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THE ISSUES SURROUNDING THE COLLAPSE OF DREXEL BURNHAM LAMBERT

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

LESSONS TO BE LEARNED FROM THE DREXEL FAILURE AND POSSIBLE REGULATORY CHANGES

MARCH 2, 1990

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CONTENTS

FRIDAY, MARCH 2, 1990

Page
Opening statement of Chairman Riegle 1
Opening statements of:
  Senator Dixon 4
  Senator Sasser 4
  Senator Gramm 60
  Senator Shelby 60
  Senator Pressler 63
  Senator Wirth 63
  Senator Bond 64
  Senator Dodd 65

WITNESSES

Richard C. Breeden, Chairman, Securities and Exchange Commission, Washington, DC 5
  Prepared statement 11
    I.—Executive summary 13
    II.—The holding company structure 16
    III.—SEC and self-regulatory organization financial responsibility requirements 17
      A. Net capital rule 19
      B. NYSE authority 26
      C. Customer protection rule 27
    IV.—Events leading to Drexel default 29
    V.—Events after the Drexel default 47
      A. Liquidation of Drexel positions 47
      B. DBL's customer accounts 54
    VI.—Implications of the Drexel insolvency 56
    VII.—Conclusion 58
  Response to written questions of:
    Senator Riegle 112
    Senator Sasser 146
Jerome Kohlberg, Jr., general partner, Kohlberg and Co., New York, NY 95

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Merrill Lynch & Co., statement on the impact that high-yield bonds have had on corporate America and the economy in general by law firm of Swindler and Berlin 106

THE ISSUES SURROUNDING THE COLLAPSE OF DREXEL BURNHAM LAMBERT

FRIDAY, MARCH 2, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee) presiding.

Present: Senators Riegle, Dodd, Dixon, Shelby, Graham, Wirth, Bryan, D'Amato, Gramm, Bond, and Pressler.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance this morning. I know there are a number of people outside the room that hope to get in during the course of the morning because there's a great interest in the subject we will be taking up today.

Before we get into the substance of this morning's hearing, I want to announce for the record that as members arrive they will be recording their votes on five Presidential nominations that are pending before the committee.

The nominations upon which we will be voting are as follows: Mr. Arthur Hill, to be President of the Government National Mortgage Association; Philip Lochner, Jr., to be a member of the Securities and Exchange Commission; John Adair, to be inspector general of the Resolution Trust Corporation; Frank Sollars, to be a member of the board of directors of the National Consumer Cooperative Bank; and Carol Mayer Marshall, to be Superintendent of the Mint of the United States at San Francisco.

We will begin the period for voting now and it will extend until this hearing concludes. If a quorum is established during that period of time the final vote will be announced as we adjourn and the nominations will be reported to the full Senate today, assuming they are all reported out favorably.

I might just say to the SEC Chairman, our first witness today, that, as you know, we moved very quickly on Mr. Lochner, which is a matter of interest to you and the Commission, and so we have him ready to roll here.

I want to make an opening statement with respect to the focus of this morning's hearing and then I will yield to Senator Dixon for his opening comments.

This morning the committee is going to consider the issues surrounding the collapse of Drexel Burnham Lambert. We have asked our first witness, SEC Chairman Richard Breeden, to discuss the lessons that are to be learned from the Drexel failure.

We have also requested that he address those regulatory changes, if any, that he believes are necessary for us to consider. Our concern here is focused on the flow of funds between the broker-dealer and its parent, especially in light of the approximately $300 million that went between the Drexel companies in their final week.

In addition, we requested Chairman Breeden to help us anticipate any possible ripple effects resulting from Drexel's bankruptcy. Our continuing concern about junk bonds requires us to consider whether Drexel's failure will cause companies that issue these bonds to default because they are unable to raise new capital.

We must also consider whether large holders of junk bonds such as insurance companies, pension funds, and savings and loans will suffer substantial losses and even possibly the prospect of failure if these bonds decline further in value.

I have also asked Chairman Breeden to respond today to a letter that was addressed to him on October 5 of last year regarding junk bonds and leveraged buyouts. In that letter, I asked whether the Federal Government (1) knew the kinds of financial institutions that owned junk bonds and in what amounts; (2) whether a liquid market for these bonds exists; and (3) whether a modernized disclosure and quotation system for these bonds should be created. Of course, these questions, which are still outstanding, take on even greater importance in light of subsequent events.

Our second witness is Mr. Jerome Kohlberg. Mr. Kohlberg has been asked to deal as he sees fit with many of the same topics, as well as his views regarding what additional prudent practices should be followed in the future with respect to debt financed change of control type transactions. I view him as a singularly valuable expert nongovernment witness and I will have more to say about his appearance when I introduce him when he comes forward.

Now there are a host of other issues which the committee will want to consider this morning and let me mention just a few of the more important ones.

First, what will this collapse possibly mean for future financial services modernization, including Glass-Steagall reform and the question of whether banking and commerce should be merged.

In answering this question, we should determine whether the Drexel broker-dealer and its holding company dealt with each other at arm's length or whether the parent improperly raided the assets of its subsidiary. If Drexel had owned a bank, would firewalls have prevented the bank from lending to the holding company or would federally insured funds have been used in a last ditch effort to bail out its parent?

Second, transactions by Drexel's commodity subsidiary occurred immediately before the default of the firm. I think we need to learn what kinds of transactions occurred and how aggressively the Government monitored or was able to monitor these transactions.

Third, we will also ask about the bonuses that were paid just weeks before the bankruptcy and the status of the SEC's investigation into the Drexel limited partnerships that allegedly gave preferential treatment to Drexel insiders.

Apparently, Drexel agreed to indemnify the persons who participated in these partnerships and we will ask whether the SEC is examining these indemnification agreements and whether efforts will be made to have them voided.

Fourth, whether the Government plans to bring a failure to supervise enforcement action against anyone at Drexel.

One final note. The Drexel failure clearly demonstrates the importance of swiftly enacting the Market Reform Act, which has been approved by this committee and will be considered by the full Senate shortly. If the risk assessment provisions of that bill had already been in effect, regulators would have been informed of Drexel's true financial position at an earlier time, in my opinion.

So I want to thank both of our witnesses for appearing today. I know we have a lot of ground to cover. Let me just say one other thing. Next Tuesday, March 6, Senator Dodd will be holding a Securities Subcommittee hearing on the condition of the securities industry. He has assembled an excellent group of witnesses for that hearing. I hope that hearing will follow up many of the subjects that we will be laying out in our discussion this morning.

With that, let me yield to Senator D'Amato.

Senator D'Amato. Thank you very much, Mr. Chairman.

I don't intend to take a great deal of time at this time because I'm interested in hearing the Chairman's response to a number of the questions which you put forth to him.

At this time, I would like to say that Senator Heinz has asked me to convey to Chairman Breeden his respect and to commend you, Mr. Chairman, for these hearings. He hopes to be here. He is part of the Pepper Commission and they are going to be making their report today, but he would like to get here, so I extend his apologies.

Mr. Chairman, I'm wondering if you might in your remarks touch on the question of double leveraging where funds are borrowed by a holding company, lent to a broker-dealer, and then further used as collateral for broker-dealer borrowing. It's been suggested that that may have been one of the reasons that Drexel went down so quickly.

Is there a need to regulate this technique to promote market stability? Are you considering this? How big a problem does it pose? Is it unnecessary exposure? I would certainly be appreciative of hearing your insights.

Some have suggested to me that this may be the case, but I would be deeply appreciative if you might take the time to comment on this.

I thank you, Mr. Chairman.

The Chairman. Thank you, Senator D'Amato.

I know Senator Heinz has a keen interest in the issues that we are raising today. He is, however, a member of the Pepper Commission, now headed by Senator Rockefeller, which is scheduled to make their final decisions this morning. So I know he will be coming back and forth between those meetings.

Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator Dixon. Mr. Chairman, I'm pleased to be here as you conduct these hearings on the collapse of Drexel Burnham Lambert. I commend you for scheduling this hearing and I look forward to the testimony of the Chairman of the Securities and Exchange Commission.

Drexel's rapid demise both raises significant practical questions about our financial system and signifies I think the decline of various questionable practices. Some of the practices in which Drexel allegedly engaged were illegal. Some made questionable financial sense and many made no economic sense.

Junk bonds fueled takeovers and leveraged buyouts which were unproductive and counterproductive for our economy, for working men and women, and for many communities.

Mr. Chairman, Marshall Fields, a grand old department store in Chicago, has been in play by takeover artists twice within the past 3 years and I ask you, how can any company manage for the future when it's constantly concerned that it may be sold in the next quarter?

I think significant practical questions remain. I think we should use this opportunity of decline in takeover activity to pass again this year legislation like the antitakeover bill this committee passed in 1988.

What will Drexel's bankruptcy mean to the value of junk bonds? What will this mean for the solvency of various insurance companies and savings and loans? What does this regulatory restraint toward Drexel mean for the too-big-to-fail doctrine toward bank insolvencies?

Mr. Chairman, I hope this hearing will explore these and other issues and I thank you for once again turning your attention to a very important issue.

The Chairman. Thank you, Senator Dixon. We will ask other members as they come in for any initial comments they want to make.

Before we begin I have a statement from Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator Sasser. Thank you Mr. Chairman. Today we take a look at the sudden and shocking collapse of one of the great houses of Wall Street in the 1980's. Drexel fell from its exalted status even more quickly than it rose to it. Drexel rode on a wave of insider trading, market manipulation and, most of all, leverage—like never seen before. When the fragility and quite frankly, the illegality, of its operation was exposed, it plummeted back to Earth with a thud.

Now as the predators circle, and we hear about $206 million bonuses being paid just prior to the bankruptcy, I think we have to ask ourselves who were the real victims of the Drexel fiasco. To this end, I think it's critical that the SEC be able to represent the victims of Drexel's violations of the securities laws at the bankruptcy proceeding. But even more so, I think that Congress must look back over the hostile takeover/LBO phenomena, from which Drexel drew its billions in profits.

Mr. Chairman, we need to make sure that this period of excesses and illegality, in our securities markets is not repeated. We need to create a climate where corporations can plan for the future and make the investments that America needs, without the fear of a Sir James Goldsmith putting them in play with a junk bond takeover.

We need to make the securities markets places where people invest for the long-term, rather than look for the quick buck. The fact that Drexel would be paying hundreds of millions in bonuses just before its failure, typifies the short-sighted hustles and the scams that became commonplace in the 1980's.

Bonuses should be paid to those that bring profits and prosperity—real economic worth—to transactions. Unfortunately, I see little good in the mountains of debt that Drexel's managers brought to corporate America in the 1980's.

Mr. Chairman, I invite the members of the committee and the public to review the legislation that my colleague the Senator from North Carolina and I have introduced. This bill would be an important first step in encouraging long-term investment and in eliminating many of the Drexel abuses of the securities laws. Thank you.

The CHAIRMAN. Chairman Breeden, let me say now to you that we appreciate the job you are doing. A number of interesting assignments and tasks that have come early in your time at the SEC; your response has been quick and effective in each instance, and that is appreciated by all. So we appreciate the good work you are doing and we are very interested to hear your presentation this morning. We'd like you to proceed.

STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. BREEDEN. Thank you.

Chairman Riegle and members of the committee: I appreciate the opportunity to testify before you today regarding the financial failure of Drexel Burnham Lambert Group Inc., which I will refer to frequently as Drexel; and the effect of that failure on its two principal regulated subsidiaries, Drexel Burnham Lambert Inc., which was and is a registered broker-dealer; and Drexel Burnham Lambert Government Securities, Inc., a registered Government securities dealer. Because of the importance of financial soundness to the functioning of our financial markets, it is useful to consider this particular failure, and to learn why and how it happened. As soon as possible, we should also look at the implications to be drawn to prevent future problems that could inject systemic risk into the marketplace.

At the outset, let me emphasize that the insolvency of Drexel Burnham Lambert Group should not be taken as an indication that U.S. securities markets, or other major market participants, are financially unsound. The roots of the Drexel insolvency arose from circumstances specific to that firm. Among large securities firms, Drexel was uniquely concentrated in high yield securities. That concentration proved to be fatal when these high yield securities became unmarketable and unpledgeable. In a sense, this is an old and all too familiar story. The Drexel parent borrowed billions of dollars short in order to lend long. Such a strategy inevitably exposes a firm to failure if total confidence in the firm is not continuously maintained.

Let me also note at the outset that what was once a $28 billion company has been reduced in size to date by roughly 75 percent. Customers, counterparties and others who dealt with the broker-dealer subsidiary of Drexel, and its Government securities subsidiary, have been protected against loss. Most importantly, the American public was not called upon to pay the creditors of Drexel's unregulated operations.

The bankruptcy of Drexel Burnham Lambert Group, the holding company parent of the broker-dealer and the Government securities subsidiaries, is the story of an integrated financial services empire, the fortunes of which were inextricably tied to the junk bond market it created. Drexel experienced a range of problems as it slid from its former position as one of the largest, and at one time one of the most profitable, securities firms. These problems included the fact that the company by its own admission had previously engaged in a widespread pattern of fraud and crime.

The complaint by the Commission and the subsequent guilty plea of the firm to multiple felonies resulted in stiff fines and other sanctions. The firm's conduct also created significant ongoing contingent liabilities and undercut its credibility in the marketplace.

Drexel also had a serious problem that is all too familiar to this committee—bad loans. Over the years, it acquired huge volumes of junk bonds for its own portfolio. Some of these securities, though not all of them, were among the least liquid and most speculative of junk bond issues. These "problem loans"—because they were a securitized loans in effect—were held in both the broker-dealer and the parent organization.

Drexel had a large base of capital in its broker-dealer. Total "haircuts" and net capital exceeded a billion dollars at year end of 1989. However, the capital in the broker-dealer was, to a high degree, the proceeds of debt, not equity, of the parent. Drexel indulged in what is otherwise known as "double leverage" more than any other large firm on Wall Street.

In addition to the double leverage in its capital structure, the Drexel parent organization was a highly leveraged company, with substantial unsecured borrowings at the holding company, funding an illiquid portfolio of high-yield bonds, private placements and other investments. The Drexel parent had over a billion dollars in short term and unsecured borrowings. To my knowledge Drexel also did not have committed bank lines to support these unsecured borrowings or to assure it access to liquidity.

As the market for junk bonds deteriorated throughout the fall of 1989, and the mergers and acquisitions business also slowed, Drexel's revenue stream from trading and underwriting junk bonds declined substantially. Drexel's junk bond inventory was increasingly illiquid, and it was declining significantly in value. Without a source of funds and earnings to finance this portfolio, Drexel's dependence on outside financing sources grew with each succeeding month. The regulated broker-dealer and Government securities dealer subsidiaries continued to finance their activities primarily through secured bank loans and repurchase agreements. However, Drexel, the parent company, and its unregulated affiliates became increasingly dependent on the short-term credit markets, borrowing as much as $1 billion on an unsecured basis through the issuance of commercial paper and through financing transactions involving the commodities markets. This situation led Standard & Poors to lower its rating for Drexel-issued commercial paper in December 1989, which made it even more difficult for Drexel to refinance its short-term loans as they came due.

Commencing approximately in January of this year, the holding company began to meet its demands for cash by using the only remaining liquidity available to Drexel. That was the excess capital of the broker-dealer and the Government securities dealer subsidiaries. Fortunately, the broker-dealer had sold most of its retail operations in June 1989, resulting in the transfer of in excess of 300,000 public accounts to the firm of Smith, Barney. However, notwithstanding the transaction with Smith, Barney in June, approximately 30,000 public accounts with approximately $5 billion in assets still remained in Drexel as of February of this year.

During January 1990, Drexel withdrew approximately $400 million from the broker-dealer and the Government securities dealer, thereby substantially reducing the capital cushion for both firms. The firm did not notify the SEC or the New York Stock Exchange before removing these funds from the broker-dealer. Although the broker-dealer remained in compliance with its capital requirements, the removal of almost 50 percent of its excess capital over a few weeks signaled very serious problems. Especially in light of the parent firm's precarious financial position, this created the risk that the broker-dealer's customers and its counterparties could be subjected to a Securities Investor Protection Corporation or SIPC liquidation if this trend had been prolonged.

Instead of improving, however, the parent firm's liquidity problems worsened.

In the first week of February, creditors to the parent were sharply limiting the amount of credit available to the parent. In banking terms, the parent firm began to experience a "run," with creditors declining to renew unsecured loans. At the same time, counterparties and lenders to the parent, as well as to its two regulated subsidiaries, were seeking markedly larger collateral positions for their secured loans. This caused the shrinkage in the firm's liquidity position to accelerate.

The rate at which capital of the broker-dealer was being "upstreamed" to pay the obligations of the parent correspondingly increased.

Under these circumstances, on February 7, the SEC and the New York Stock Exchange informed the company in writing that the broker-dealer's capital could not be further depleted or transferred to the parent without prior notice and approval of both the New York Stock Exchange and the Commission. This action was necessary in part due to the difficulty in accurately valuing the broker-dealer's portfolio securities for purposes of determining whether it had sufficient capital.

In making the decision to act quickly, it was clear that we had a choice of allowing the broker-dealer's excess capital to be exhausted completely in order to postpone a default by the parent company for another 24 to 48 hours, or to protect the broker-dealer's capital and to allow Drexel and its unregulated affiliates to default. Without hesitation, we chose to ensure the ability of the broker-dealer to effect an orderly wind-down, and thereby to protect those 30,000 customer accounts with more than $5 billion in customer property. By maintaining the regulated broker-dealer's solvency, we were also able to protect other broker-dealers and their customers from defaults on trades involving billions of dollars in securities.

As events unfolded during the past 3 weeks, we worked very closely with the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, the New York Stock Exchange, the CFTC, and other appropriate organizations. Treasury Secretary Nicholas Brady, Fed Chairman Alan Greenspan, New York Fed President Gerald Corrigan, and I were in frequent communication, and our staffs worked with the highest degree of cooperation. I would this morning like to commend personally the skill and professionalism of the staffs, in particular of the Federal Reserve Bank of New York, of the New York Stock Exchange, and if I might say, the staff of the SEC, and other organizations, all of whom worked extraordinarily hard, sometimes through the night, to minimize the consequences on the market of the Drexel parent's bankruptcy and to facilitate the sale of tens of billions of dollars in financial market positions of all kinds.

Once the dimensions of Drexel's financial difficulties became clear, we all worked cooperatively to protect public investors and customers and to reduce the potential risks to the financial system itself. Working particularly closely with the New York Fed, we sought to facilitate an orderly liquidation of the broker-dealer's positions and a speedy transfer of customer accounts to other financial institutions. This effort involved many specific actions, including working with banks, securities firms, clearing agencies and other interested parties to reduce settlement logjams and to prevent a financial gridlock. Several private organizations played very constructive roles in this process.

As of today, the liquidation of the inventory positions at the broker-dealer and the Government securities dealer is not yet complete. However, the assets and liabilities on the books of these two firms have been sold or otherwise eliminated to a vast degree. Total assets of these two firms, which amounted to about $20 billion on February 1 of this year, have been reduced to approximately $8 billion. Of this amount, we anticipate further significant reductions in the very near term as transactions currently in progress are completed. Moreover, more than 75 percent of the broker-dealer's customer accounts have now been transferred, and the remainder are in the process of transfer out of the firm. Most significantly, through the swift action of the financial regulators, all of this has been accomplished without one penny in cost to the American taxpayer.

I also want to share with you this morning some preliminary conclusions regarding lessons that should be drawn from this episode. The events surrounding the Drexel insolvency underscore the need for the SEC to have regular and unquestioned access to information regarding the financial position of a broker-dealer's holding company and its other affiliates. In order for us to anticipate problems in broker-dealers, we must have information on how broker-dealer holding companies and their related entities fund their operations, allocate their capital, and manage risks inherent in their businesses. This is essential in order to know whether a liquidity crisis is imminent for a firm, and to understand and appreciate the corresponding risk that the broker-dealer's capital could be depleted in what could prove to be a fruitless attempt to pay the parent firm's unsecured creditors.

Therefore, I urge the Senate to pass promptly the pending Market Reform Act this committee has forwarded to the floor of the Senate and that would help ensure that we have access to such data. I do not believe that our markets, and the tens of millions of public shareholders, should be exposed to sudden risk of loss due to hidden problems in a controlling entity, a parent firm.

We believe that our current net capital rule is generally sound. Nevertheless, I have also asked the SEC staff to commence an immediate review of the rule in light of our experiences in this situation. Capital is the critical element in achieving systemic stability, and we will propose any regulatory or legislative modifications we determine, after careful study, to be necessary to ensure capital adequacy.

The CHAIRMAN. Let me just say on that point, if you would develop a recommendation and forward it to this committee, we will take it up very quickly.

Mr. BREEDEN. Thank you, Mr. Chairman. I do expect that we will seek public comment on some proposed rule changes in the very near future. We have extensive authority in the capital area, and I want to make sure before we ask the Congress to change the legislative framework that we have done everything we should under our own existing authority. But we will be looking very intensively and very actively at this subject.

Finally, the clearance and settlement system deserves immediate attention. As you know, Mr. Chairman, one title of the Market Reform Act would authorize the SEC to create national rules where necessary to adopt an efficient and effective clearance system. Swift and reliable procedures for clearing transactions in all types of portfolio instruments are vital to the ability to reduce the size of a failing firm in an orderly manner. It's one thing to know that you have a problem situation on your hands, but, once you have it, you need to be able to reduce the size of that problem in a steady and orderly manner. It is vital that the clearance and settlement process continue working smoothly and efficiently, and that those who would buy some of the positions of a failing firm can be assured that they will not become caught up in insolvency proceedings that might occur in the midst of that clearance and settlement process.

The SEC strongly supports this legislation in the market reform area. It would give us better authority, together with the CFTC, to coordinate the clearance and settlement systems, as well as the ongoing efforts of the Group of 30 to achieve worldwide improvements to clearance and settlement systems.

In conclusion, Mr. Chairman, I would like to reiterate that the Drexel case shows the strength and resilience of our marketplace. There have been costs and dislocations, which I would not want to minimize, for Drexel's employees, creditors, and customers. However, the market swiftly absorbed the facts concerning Drexel's problems, and there was not any loss of confidence in the stability of the overall system. The regulators were able to move promptly and vigorously to protect the regulated entities—both the broker-dealer and the Government securities firm—and to work with market participants to assist in the orderly sale and liquidation of Drexel's assets and the transfer of its customer accounts.

I would like to have had more advance warning of the holding company's problems, its decision to remove a significant portion of the broker-dealer's excess capital, and of the nature of some of its worldwide borrowings. However, working with all the other Government agencies, securities and futures exchanges, and private market participants, we were able to resolve this problem in an orderly manner and without cost to the American taxpayer.

Mr. Chairman, thank you very much and I would be happy to address the questions you suggested at the outset and Senator D'Amato mentioned, and any others that the committee may have.

[The complete prepared statement of Richard C. Breeden follows:]

STATEMENT OF RICHARD C. BREEDEN
CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION
BEFORE THE COMMITTEE ON BANKING,
HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
CONCERNING THE BANKRUPTCY OF
DREXEL BURNHAM LAMBERT GROUP INC.

Chairman Riegle and Members of the Committee:

I appreciate the opportunity to testify before you today regarding the financial failure of Drexel Burnham Lambert Group Inc., and its effect on its two principal regulated subsidiaries, Drexel Burnham Lambert, Inc., a registered broker-dealer, and Drexel Burnham Lambert Government Securities, Inc., a registered government securities dealer. Because of the importance of financial soundness to the functioning of our financial markets, it is important that we focus our attention on this particular failure to learn why and how it happened. As soon as possible we should also look at the implications that should be drawn to prevent future problems that could inject systemic risk into the marketplace.

At the outset, let me emphasize three points. First, the insolvency of Drexel Burnham Lambert Group Inc. should not be taken as an indication that U.S. securities markets, or other major participants in those markets, are financially unsound; the roots of this insolvency arose from circumstances unique to the firm. As discussed in detail below, Drexel was uniquely concentrated among large securities firms in high yield securities, and that concentration proved to be fatal when these securities became unmarketable and unpledgeable. In a sense, this is an old and all too familiar story: Drexel's parent borrowed billions short in order to lend long. Such a strategy inevitably exposes the firm to failure if total confidence in the firm is not continuously maintained.

Second, it should be noted that what was once a $28 billion company has been reduced in size to date by roughly 75 per cent. Customers, counterparties and others who dealt with the regulated broker-dealer subsidiary of this firm have been protected, and the public was not called upon to pay the creditors of Drexel's unregulated operations.

Third, the events I am about to describe underscore the need for prompt action by the Congress on the Market Reform Act, S. 648, which this Committee approved in the closing days of the last session. The Commission must have regular information regarding a broker-dealer's holding company and related corporate organization if market participants, lenders and public customers are to maintain confidence in the integrity of broker-dealers and U.S. securities markets. The Market Reform Act would give the Commission the tools and the information it needs.

I. EXECUTIVE SUMMARY

The bankruptcy of Drexel Burnham Lambert Group Inc. ("Drexel"), the holding company parent of Drexel Burnham Lambert Inc. ("DBL"), a registered broker-dealer, and Drexel Burnham Lambert Government Securities Inc. ("GSI"), a registered government securities dealer, is the story of an integrated financial services empire, the fortunes of which were inextricably tied to the junk bond market it created. It was a highly leveraged company, with substantial unsecured short-term borrowings at the holding company level, funding an illiquid portfolio of high yield bonds, private placements and other investments. Drexel also did not have committed bank lines to support the unsecured borrowings.

As the market for junk bonds deteriorated through the fall of 1989, and the mergers and acquisitions business also slowed, Drexel's revenue stream from trading and underwriting junk bonds declined substantially. Without a source of funds to finance its increasingly illiquid inventory, Drexel's dependence on outside financing sources grew with each succeeding month. The regulated broker-dealer (DBL) and government bond dealer (GSI) subsidiaries continued to finance their activities, primarily through secured bank loans and repurchase agreements. However, Drexel and its unregulated affiliates became increasingly dependent on short-term credit markets, borrowing as much as $1 billion on an unsecured basis through the issuance of commercial paper and through financing transactions involving the commodities markets.

Drexel's primary assets, which were privately placed debt and equity investments and non-investment grade corporate debt, became increasingly illiquid over a period of months coupled with declining revenues flowing from DBL's core business lines, this situation led Standard & Poors to lower its rating for Drexel-issued commercial paper in December 1989. This action made it even more difficult to roll over its short-term loans as they came due.

Commencing approximately in January 1990, the holding company's demand for cash was met by employing the only remaining liquidity available to Drexel. This was the excess capital of DBL and GSI. Fortunately, DBL had sold most of its retail operations in June 1989, resulting in the transfer of in excess of 300,000 public accounts to Smith Barney. However, approximately 30,000 public accounts remained in the firm, with approximately $5 billion in assets. During January 1990, Drexel withdrew approximately $400 million from DBL and GSI, thereby substantially reducing the capital cushion for both firms. In light of Drexel's precarious financial position, this created the risk that DBL's customers and its counter-parties could be subjected to a Securities Investor Protection Corporation ("SIPC") liquidation.

Under these circumstances, on February 7th, the SEC and the New York Stock Exchange ("NYSE") took decisive action to ensure that DBL's capital could not be further depleted without prior notice and approval of both the NYSE and the SEC. This action was necessary in part due to the difficulty in accurately valuing DBL's portfolio securities for purposes of determining whether it had sufficient capital.

As events unfolded during the past three weeks, we worked very closely with the Department of the Treasury ("Treasury"), the Board of Governors of the Federal Reserve System ("FRB"), the Federal Reserve Bank of New York ("NY Fed"), the NYSE and other appropriate organizations. Treasury Secretary Nicholas Brady, FRB Chairman Alan Greenspan, NY Fed President Gerald Corrigan, and I were in frequent communication, and our staffs worked with the highest degree of cooperation.

Once the dimensions of Drexel's financial difficulties became clear, we worked cooperatively to protect public investors and customers and to reduce the potential for systemic risks of a cascade of failures. Working particularly closely with the NY Fed, we sought to facilitate an orderly liquidation of DBL's positions and a speedy transfer of customer accounts to other financial institutions. This effort involved many specific actions, including working with banks, securities firms, clearing agencies and other interested parties to reduce settlement logjams and to prevent financial gridlock.

As of today the liquidation of the inventory positions at DBL and GSI is not yet complete. However, the vast majority of the assets and liabilities in the books of the two firms, has been liquidated or unwound. Total assets of these two firms which amounted to $20 billion on February 1, 1990, have been reduced to $8 billion. Of this amount, we anticipate further significant reductions in the very near term as transactions currently in progress are completed. Moreover, more than 75 percent of DBL's customer accounts have been transferred. Most significantly, through the swift action of financial regulators, all of this has been accomplished without a single penny in cost to American taxpayers.

The remainder of my written statement provides a detailed description of the structure and operation of Drexel, DBL and GSI; a brief description of the SEC's financial responsibility rules; a chronology of events of the past several weeks; and, finally, what I believe are at least preliminary conclusions regarding lessons that should be drawn from this episode regarding the need for future action.

II. THE HOLDING COMPANY STRUCTURE

Drexel was a financial services firm with many subsidiaries and business activities, concentrated in financial, commodities, and securities markets throughout the world. On a consolidated basis, the holding company and its subsidiaries, as of December 29, 1989, had approximately $28 billion in assets, [1] and $835,725,000 in stockholder's equity. As of that date, the holding company's long-term borrowings were approximately $950 million and short-term borrowings were approximately $2.5 billion.

The most significant subsidiaries in Drexel, in terms of revenues and profits, were DBL, the registered broker-dealer; GSI, the registered government securities dealer; DBL Trading Corp ("DBL Trading"), an entity that engaged in extensive foreign exchange and commodities trading, and DBL International Bank, NV, a Curacao corporation through which Drexel conducted many of its foreign operations. As of December 29, 1989, DBL had assets of about $9.4 billion, total capital (including subordinated debt) of $1.6 billion, and excess net capital of $684.7 million.

III. SEC AND SELF-REGULATORY ORGANIZATION FINANCIAL RESPONSIBILITY REQUIREMENTS

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[1] This figure tends to understate the size of the firm because several of the subsidiaries had multi-billion dollar forward commitments in foreign exchange, interest rate swaps, government securities and mortgage-backed securities. These are not ordinarily booked as assets and liabilities under generally accepted accounting principles.

The core of the Commission's financial responsibility program is our net capital and customer protection rules. The NYSE, of which DBL is a member organization, also has the authority to set net capital requirements for a member organization that are higher than the Commission's, and to impose restrictions on the withdrawal of funds from a member firm. Under current law, neither the SEC nor the NYSE has regulatory oversight over the activities of the parent company of a broker-dealer or its other affiliates. The Commission's net capital and customer protection rules apply to registered broker-dealers and, with minor exceptions, do not encompass the assets and liabilities of parent or affiliated entities.

My testimony will focus on this regulatory structure as it applies to NYSE member broker-dealers, such as DBL, registered under Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"). In addition to being a member of the NYSE, DBL is a member of most stock and commodity exchanges, the National Association of Securities Dealers, Inc. ("NASD"), and securities and commodities clearing organizations.

DBL is also a member of SIPC, the organization that was created by the Securities Investor Protection Act of 1970 to provide protection to securities customers of SIPC member broker-dealers that fail financially. With some minor exceptions, all broker-dealers registered under Section 15(b) are members of

SIPC. Customers of those broker-dealers are protected in a liquidation for up to $500,000 in securities and cash (with maximum protection for cash claims of $100,000) to satisfy customer claims.

GSI is also a member of the NASD. Broker-dealers, such as GSI, that limit their securities activities solely to U.S. government securities and that are registered under another section of the Exchange Act, Section 15C, are not members of SIPC. These broker-dealers are subject to financial responsibility rules and regulations adopted by the Treasury and enforced by the SEC and the self-regulatory organizations. These requirements are substantially similar to the Commission's requirements.

A. NET CAPITAL RULE

The fundamental purposes of the Commission's net capital rule, Rule 15c3-1 under the Exchange Act, are to ensure that broker-dealers maintain sufficient liquid assets to satisfy promptly the claims of customers and broker-dealers and to provide a cushion of liquid assets in excess of liabilities to cover potential market and credit risks. The rule essentially requires a broker-dealer to cover each dollar of its liabilities (except for subordinated liabilities that are treated as part of the broker-dealer's capital) with more than one dollar of liquid assets. The rule generally requires a 100% charge to capital for unsecured credit exposure such as bridge loans. The rule also requires a broker-dealer to reflect its securities and commodities positions at current market prices (e.g., marking to market the value of those positions daily). In addition, the rule requires the broker-dealer to deduct a percentage of the value of securities position ("haircut") to reflect possible future market losses in liquidating the positions. The rule thus attempts to account for the risk and exposure in a broker-dealer in a very conservative fashion.

With certain exceptions, the net capital rule requires a registered broker-dealer to maintain specified amounts of net capital in relation to either its liabilities (if the firm operates on the basic method of computing net capital) or its securities customer-related receivables (if the firm operates on the alternative method of computing net capital). As do almost all large broker-dealers, DBL operates on the alternative method for computing net capital. This method requires a broker-dealer to maintain net capital equal to the greater of 2% of its customer-related receivables or 4% of the funds required to be segregated pursuant to the Commodity Exchange Act if the broker-dealer is also registered as a futures commission merchant under that Act. Customer-related receivables are the monies owed to the broker-dealer by its customers and other customer-related assets of the broker-dealer. 2/ I will refer to these minimums as base requirements.

The term "net capital" is defined in the rule. Its computation begins with net worth, as computed under generally accepted accounting principles. To that number is added back liabilities properly subordinated to the claims of creditors including customers. The broker-dealer then deducts from that number assets considered not readily convertible into cash. This includes goodwill, furniture and fixtures, buildings, prepaid expenses, and exchange seats. The broker-dealer also deducts most unsecured receivables, including bridge loans to finance LBO transactions, and charges for inefficiencies in processing securities transactions and bookkeeping problems. From that number, the broker-dealer deducts certain percentages, called haircuts, of the market value of proprietary positions, including junk bonds. At the end, a broker-dealer with a positive net capital has more than one dollar of liquid assets for each dollar of liabilities (except for those liabilities properly subordinated to creditors). This amount of net capital must exceed the base requirement.

2/ As applied to government securities dealers generally, and GSI in particular, the Treasury's requirements provide that net capital before haircuts must exceed 120% of haircuts or $25,000, whichever is greater.

In the net capital computation, securities positions must be marked-to-the-market to reflect current values. Thus, all dimunitions in value of securities positions held by a broker-dealer are included, even though no transaction has taken place to precipitate recognition of a loss. The haircuts taken on the current value of proprietary positions are deducted from net worth in order to provide a margin of safety against losses that may be incurred by broker-dealers as a result of market fluctuations in the price of securities.

Certain subordinated liabilities are permitted to be included as part of the regulatory net capital of a broker-dealer. To be included, the liabilities, among other things: (1) must be subordinated to the claims of all present and future creditors, including customers; (2) must be approved for inclusion as regulatory capital by the broker-dealer's self-regulatory organization; (3) may not be repaid if the repayment would reduce regulatory net capital below certain required amounts; and (4) must have an initial term of one year or more.

The net capital rule requires a broker-dealer to take a 100 percent charge to its net worth for proprietary securities positions that cannot be sold and payment received in a reasonably prompt fashion. Thus, securities or other assets that do not have a ready market, as well as securities that must be registered with the Commission under the Securities Act of 1933 before being sold, are considered to have a value of zero for purposes of computing net capital.

If a security can be sold reasonably promptly, the amount of the haircut then depends on the nature of the security. Under the alternative method of computing capital, these deductions range from 15% of the market value of equity and non-investment grade bond positions, to extremely small haircuts for short-term U.S. Government bonds. 3/

3/ For debt securities, the haircuts depend on the specific security and the composition of the positions. Generally, the debt security haircuts take into account market risk, credit risk, price volatility, and liquidity of the particular debt instruments. For example, U.S. government securities receive haircuts ranging from 0% for those maturing in less than three months to 6% for those maturing in twenty-five years or more.

Non-convertible debt securities (*i.e.*, corporate bonds) with fixed interest rates and fixed maturity dates and that are not traded flat (*i.e.*, without accrued interest) or in default as to principal or interest and that are rated in one of the four highest rating categories ("investment grade") by at least two nationally recognized statistical rating organizations receive haircuts ranging from 2%, if they have less than one year to maturity, to 9%, if they have twenty-five or more years to maturity. Non-convertible debt securities that are not investment grade receive haircuts of 15%. Readily marketable junk bonds fall into this latter category and receive a 15% haircut under current rules.

Reduced haircuts are permitted for certain debt securities that are hedged by other debt securities within certain maturity parameters. Hedging is a strategy designed to protect a position in securities against price movements by taking an offsetting investment position. Junk bonds do not qualify for this reduction of haircut percentage.

In addition, the rule provides for concentration charges under certain circumstances. In the case of proprietary securities of a single class or series of an issuer that have a market value of more than 10 percent of the broker-dealer's net capital before haircuts, there is an additional deduction equal to 50 percent (100 percent for equities and junk bonds) of the normal haircut deduction on the amount in excess of 10 percent of the broker-dealer's net capital before haircuts.

It is important to emphasize that the present statutory scheme focuses solely on the registered broker-dealer. Accordingly, under the Commission's net capital rule, the assets and liabilities of a related entity of the broker-dealer are not taken into account in computing net capital. 4/

In addition to the minimum base requirements, the net capital rule and the rules of the various regulatory organizations contain early warning levels below which a firm's net capital cannot fall without adverse consequences to the firm.

4/ One of the primary exceptions to this principle is where the broker-dealer guarantees the liabilities of the related entity. In such a situation, the broker-dealer consolidates in a single computation the assets and liabilities of both itself and the guaranteed entity. If the consolidation results in an increase in the broker dealer's net capital, the increase can only be taken into account if the broker-dealer provides its self-regulatory organization and the Commission with satisfactory assurance that the net asset value of the guaranteed entity can be expeditiously distributed to the broker-dealer in the event of a SIPC liquidation of that broker-dealer.

For example, under the Commission's net capital rule, a firm, such as DBL, may not withdraw equity capital in any form to pay shareholders if its net capital is less than the greater of 5% of its customer-related receivables or 7% of the funds required to be segregated pursuant to the Commodity Exchange Act.

To sum up, a key feature of the net capital rule is that all securities and commodities are marked-to-market on a daily basis. All intangible and illiquid assets, as well as operational and bookkeeping charges, are deducted from net worth and subordinated liabilities to arrive at net capital. Most unsecured receivables are treated as illiquid assets and, therefore, are also deducted from net worth. The remaining net capital of the broker-dealer then must be greater than the sum of the haircuts and base requirement. The amount of net capital after haircuts and in excess of the base requirement is commonly referred to as "excess net capital."

As of December 29, 1989, DBL reported net worth and subordinated liabilities of about $1.6 billion. It had deductions from this figure of about $169.6 million for illiquid assets and operational and bookkeeping charges. This left DBL with net capital, before haircuts, of about $1.43 billion. DBL's haircuts were about $560 million on its bond inventory (including junk bonds) and about $172 million on its other securities positions. DBL's base requirement was about $16.7 million.

Accordingly, DBL's capital requirement was $748.7 million 5/ in liquid assets in excess of liabilities (excluding subordinated liabilities). DBL reported to the NYSE and the Commission that as of December 29, 1989, it had $684.7 million in excess net capital beyond the $748.7 million in required regulatory capital.

B. NYSE AUTHORITY

In addition to the Commission's net capital rule, the NYSE has the authority to impose higher capital requirements on a member organization. NYSE Rule 325 permits the NYSE, among other things, to prescribe at any time greater net capital requirements than those prescribed by the Commission's net capital rule for a particular member organization. Rule 325 also allows the NYSE to impose more stringent treatment in valuing assets (such as portfolio securities) or other items in computing the member's net capital requirement.

Pursuant to Rule 326, the NYSE has authority, among other things, to place financial restrictions on a member organization. This can include prohibiting advances to an officer, director, parent, or affiliate if such an advance would result in net capital being less than 150% of the member organization's minimum dollar net capital requirement.

5/ This includes haircuts of $732 million plus the base requirement of $16.7 million.

Together, Rules 325 and 326 provide the NYSE with broad authority to impose stringent financial responsibility standards when a firm is faced with uncertainties in its business or potential liquidity problems.

C. CUSTOMER PROTECTION RULE

The Commission's customer protection rule, Rule 15c3-3 under the Exchange Act, also provides direct protection for securities customer funds and securities. Rule 15c3-3 has two parts. The first part requires the broker-dealer to have possession or control of all fully paid and excess margin securities of customers. Generally speaking, excess margin securities are the portion of securities bought by a customer on credit that are in excess of the amount of the securities that the broker-dealer may use to finance the customer's purchase. All customer fully-paid and excess margin securities are required to be kept segregated, and maintained free of all claims or liens. The broker-dealer must make a daily determination to ensure that it has possession or control of all such customer securities. Broker-dealers with customer securities that should be but are not within their possession or control must initiate action to obtain possession or control.

The second part of the Rule covers customer funds. It requires the broker-dealer to make a weekly computation (in accordance with a formula) to determine how much money it is holding that is either customer money or money obtained from the use of customer securities ("credits"). From that amount the broker-dealer subtracts the amount of money that it is owed by customers or by other broker-dealers relating to customer transactions ("debits"). If the credits exceed the debits, the broker-dealer must deposit the excess in a Special Reserve Bank Account for the Exclusive Benefit of Customers ("reserve account"). As a result, the Rule seeks to ensure that the broker-dealer is only using customer margin securities or free credit balances to finance other customer lending activity, and not to finance its own inventory positions, fixed investments or operating expenses. 6/

6/ Firms computing net capital under the alternative method make their formula computation weekly as of Friday. To the extent there is an excess of credits over debits, a broker-dealer must deposit cash or U.S. government securities equal to the excess into a reserve account by the following Tuesday. The bank at which the reserve account is maintained must provide the broker-dealer with a written agreement that the funds in the account are being kept for the exclusive benefit of the broker-dealer's customers, that they are being kept separate from other accounts of the broker-dealer, that they cannot be used as a security for a loan to the broker-dealer, and that they shall not be subject to any charge, security interest, loan, or claim of any kind in favor to the bank or any person claiming through the bank.

IV. EVENTS LEADING TO THE DREXEL DEFAULT

The Commission has been monitoring the financial condition of DBL and its affiliates since before the March 1989 settlement between Drexel and the United States of felony insider trading charges against Drexel. 7/ This was designed to help evaluate the impact on the firm of the agreement to pay $650 million to

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7/ On April 13, 1989, the Commission approved a settlement with DBL and Group of the Commission's injunction action that had been filed in September 1988. That settlement provided for, among other things, the entry of a Final Judgment of Permanent Injunction, three administrative orders that were subsequently issued by the Commission, and the submission by DBL and Group of its Consents and Undertakings. The Final Judgment of Permanent Injunction enjoined DBL and Group from violating or aiding and abetting violations of various sections of the Exchange Act, including the anti-fraud, margin, and recordkeeping requirements of that Act. The administrative orders, among other things, instituted public administrative proceedings against DBL pursuant to Section 15(b)(4) of the Act and granted exemptions from certain statutory disqualifications of Section 9(a) of the Investment Company Act and Rule 206(4)-3(a)(1)(ii) under the Investment Advisers Act of 1940. Without admitting or denying the allegations in the Commission's complaint, DBL and Group consented, among other things, to pay $350 million into a fund for the benefit of persons injured by DBL and Group's violations of the federal securities laws, in accordance with their agreement with the United States Attorney; to pay $15 million as a civil penalty under the Insider Trading Sanctions Act of 1984, as part of $300 million in civil and criminal penalties agreed to with the United States Attorney; to cooperate in the Commission's continuing investigations; to retain an independent special reviewer to review investment company related operations; and to effect changes in DBL's personnel and supervisory procedures.

Separately, DBL and Group agreed to enter pleas of guilty to six felony violations of the federal securities laws and the federal mail fraud statutes.

the Government and defrauded investors, as provided for in the settlement. 8/

At the time of the settlement in March 1989 and for the rest of calendar year 1989, DBL had a substantial inventory of junk bonds. The Commission had concerns over the size of this concentration, and the inherent risk such a concentration created. However, these concerns had to be balanced against DBL's extremely high net capital and net worth. As of the end of May 1989, after payment of most of the settlement, DBL had net capital before haircuts of about $1.5 billion. After haircuts for securities positions, DBL had "excess" net capital of $751.5 million. Throughout 1989, the firm's excess net capital never fell below $680 million.

Accordingly, after the settlement DBL remained among the highest capitalized broker-dealers in the United States. Although DBL did sell its retail sales network in June, it chose to continue its heavy reliance on investment banking, trading, and mergers and acquisitions activity relating to junk bond securities.

8/ Drexel has paid $500 million of this amount. It still owes $150 million to the fund and the SEC has filed as a creditor in the bankruptcy of DBL Group.

During the course of 1989, however, developments in the junk bond market were also having an adverse impact on the profitability of DBL and Drexel, as well as on the liquidity of DBL's and Drexel's substantial inventory of junk bonds.

During 1989, 47 issuers defaulted or were involved in distressed exchange offers 9/ on approximately $7.3 billion in registered junk bond securities (par value), resulting in approximately $5.0 billion in principal losses to investors. By comparison, during 1988, $3.7 billion in junk bond securities went into default or were involved in distressed exchange offers. Among those issuers that ran into problems in 1989 were the following. On June 15, 1989, Integrated Resources, a major issuer of high yield securities, was forced into default on $1 billion in commercial paper. On July 14, 1989, Southmark Corporation filed for bankruptcy. In mid August, Ohio Mattress was forced to cancel its planned offering of $455 million in high yield bond securities, and Seaman's Furniture defaulted on $85 million in junk bond securities. In late August, Resorts International defaulted on $325 million raised to finance the company's acquisition less than a year earlier. Finally, on September 13, 1989, Campeau Corporation announced that it lacked sufficient cash to satisfy its debt obligations, which was

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9/ A distressed exchange offer is defined as an exchange of an outstanding debt security for a security with a lower principal amount or with a lower interest rate.

followed by a filing for protection from creditors under the federal bankruptcy laws on January 16, 1990.

The impact of these failures manifested themselves in the junk bond market in two ways. First, secondary trading in junk bonds fell off sharply. The yield spread between Treasury and junk bond securities grew from 218 basis points at January 25, 1989, to 372 basis points at November 15, 1989. Even more seriously, following the Campeau announcement and the October 13, 1989 announcement that financing for the United Airlines buyout had fallen through, many press articles carried reports that holders were unable to locate any buyers for their junk bond securities. 10/

While the absence of volume data and transaction reports for this segment of the bond market makes confirmation of these reports difficult, the Commission staff received reports from DBL traders in December 1989 that DBL's average daily volume of trading in junk bonds had declined from $400 million per day before October 1989 to about $150 million per day in December 1989. Since DBL generally represented about 50 percent of the market in junk bond securities, this decline in volume

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10/ See Wallace, End of 'Junk Bond' Takeovers?, N.Y. Times, October 14, 1989, at 33. The Party's Over: Mounting Losses are Watershed Event for Era of Junk Bonds, Wall St. J., September 18, 1989, at A1; Winkler, Junk Market's Worst Ever Shakeout Continues with More Price Drops, Issue-Liquidity Problems, Wall St. J., September 15, 1989 at C1.

represented a significant reduction in liquidity in the junk bond market generally.

Second, and perhaps more importantly, new transactions involving the issuance of junk bond securities began to slow down, with a resultant decline in underwriting and related revenues. For example, in the immediate aftermath of the Campeau announcement, the original issue market for high yield securities dried up. In September, only approximately $500 million of new non-investment grade debt was issued, compared with a monthly average of $2.8 billion from January-August 1989.

As the junk bond market became more illiquid with the growing number of issuer defaults, and as the new offering market for junk bonds dried up, DBL's revenue stream slowed, and its inventory of junk bonds became more difficult to sell. DBL incurred losses each month from August through November 1989 (total cumulative losses for this period exceeded $126 million), although accounting adjustments in the treatment of private placements resulted in approximately $105 million of income during the month of December.

The impact of DBL's poor financial performance was increased geometrically by Drexel's dependence on short-term borrowing. Based on unaudited financial information supplied by DBL to the staff, the holding company and its subsidiaries, on a consolidated basis, as of December 29, 1989, had $28 billion in total assets. At the same time, it held approximately $1 billion in junk bonds and had $835,725,000 in stockholder's equity. As of that date, the holding company's long-term borrowings were $950 million, and short-term borrowings were $2.5 billion. Far more troubling was the continued dependence of Drexel and the unregulated affiliates on over $1 billion in short term unsecured borrowings.

Unsecured borrowing, particularly through the commercial paper market, is common for many large broker-dealer holding companies. To effect such a program conservatively, however, the holding company should hold liquid, pledgeable assets as a back-up. This would permit the Company to satisfy its liquidity needs through secured bank loans if, for any reason, it loses access to the commercial paper market. Drexel, however, held or had access to only illiquid privately placed investments in the unregulated subsidiaries and the excess uncollateralized securities inventory of DBL, its regulated broker-dealer subsidiary. DBL's uncollateralized inventory, however, also was predominantly junk bond securities, an inventory which became steadily less appealing to banks as 1989 came to a close.

In December 1989, Standard & Poor's reduced its rating on Drexel's commercial paper from A-2 to A-3. The consequence of this reduction in rating was that Drexel's commercial paper was no longer eligible to be purchased by money market funds. As a result, there was a significant reduction in the size of Drexel's commercial paper program. Drexel's outstanding commercial paper shrank from approximately $600 million to $180 million. Initially Drexel responded to this development by increasing unsecured short-term borrowing through DBL Trading. Nevertheless, the reduced pool of commercial paper lenders resulting from the ratings reduction made Drexel dependent for its unsecured financing on a very small group of institutional lenders.

During January 1990, unsecured lenders continued to pull back from financing Drexel. As a result, Drexel turned to its only remaining liquidity sources, and began drawing capital out of both DBL and GSI. DBL made these transfers without notifying either the Commission or the NYSE.

The Commission staff became aware of the increased exposure to DBL on February 2, 1990, when the staff was informed by the NY Fed that a government securities dealer had indicated that it was prepared to inform government securities broker's brokers that it would no longer trade with GSI in government securities. Such a step by a major securities firm relating to a primary dealer in the government securities market was quite unusual, and demonstrated substantial concern over GSI's short-term viability. GSI had discussions over the next several days with that dealer over the conditions under which the dealer would continue to trade with GSI. While, as a result of these negotiations, the dealer did not cut off GSI as a counterparty, the concern triggered a review by both the Commission and the NY Fed of the financial condition of DBL, GSI and Drexel.

On February 7, 1990, the Commission was informed by the staff of the NY Fed that Drexel and its unregulated subsidiaries were experiencing further funding difficulties. In particular, some holders of commercial paper (issued by the holding company) and commodity leases (owed by DBL Trading) were not rolling over their positions and were demanding immediate payment. Separately, DBL contacted the NYSE seeking to withdraw approximately $100 million from the reserve bank account for customers without first completing a new computation of DBL's reserve requirement (as required by the SEC's customer protection rule).

The staff held follow-up discussions with DBL and Drexel and confirmed the information that the NY Fed had provided. Senior DBL officials confirmed that, as a result of funding requirements at DBL, Drexel and DBL Trading, approximately $220 million had been transferred from the broker-dealer to DBL Group in the form of a loan. Those transfers, coupled with operating losses in January and increases in haircuts on securities positions, reduced the broker-dealer's excess net capital from $680 million at the end of 1989 to $330 on February 2, 1990. In addition, the staff was informed that excess capital at the GSI was below $40 million compared to normal levels well in excess of $100 million.

As a result, the Commission advised Drexel and DBL of our serious concerns regarding the substantial withdrawals of capital from DBL and the GSI. Additionally, the Commission staff accelerated a previously scheduled February 14th examination of DBL's financial condition to Friday, February 9. DBL management was also advised that it should review means of reducing the exposure or increasing the capital of DBL immediately. In addition, we sent a letter to Richard Wright, Chief Financial Officer of DBL, instructing DBL not to make further loans to Drexel or its affiliates without prior consultation with the Commission's staff. This letter was followed on February 8, 1990, by a letter from the NYSE prohibiting the firm from increasing loans or advances, paying dividends, or issuing guarantees to any related entity without the NYSE's prior written permission. 11/

On February 9, 1990, staff from the SEC's Division of Market Regulation and New York Regional Office, the NY Fed and the NYSE

11/ As discussed earlier, NYSE Rules 325 and 326 authorize the NYSE to require a member firm to maintain net capital in an amount the NYSE determines is necessary to meet the firm's financial obligations, and authorize the NYSE to prohibit the firm from advancing funds to its owners.

met with DBL, GSI, and Drexel officials to review their current financial condition and to discuss their plans to reduce its unsecured financial exposure by eliminating expenses, winding down certain of its business activities and liquidating open inventory positions on an orderly basis. SEC staff emphasized the need to move quickly, given the size of the outstanding positions and the demands for cash likely to occur during the next two weeks. However, DBL officials still maintained that Drexel was a viable company on an ongoing basis.

At the February 9 meeting, DBL reported that Drexel had incurred a $60 million loss in the month of January as a result of reduced investment banking revenue and losses on positions in a rights offering by First Executive Corporation. DBL officials also confirmed that an infusion of additional outside capital to Drexel was not likely. In particular, the Commission was advised that the Lambert Bruxelles Group, the holding company's largest shareholder, would not be a source of additional funds.

Discussions then centered on short-term financing needs in the holding company and affiliates and plans by DBL management to meet those funding needs and to achieve a more liquid position. DBL officials informed us that more than $400 million in unsecured debt issued by Drexel and affiliated entities either would mature or be callable by holders between February 20 and February 28, with an additional $330 million scheduled to mature during the month of March. While DBL officials estimated that a large number of investment banking transactions would probably close in the first quarter of 1990 and generate approximately $60 to $80 million in revenue for the firm, DBL officials indicated that they recognized the need to reduce positions and expenses to enable the firm to meet its funding requirements as they were expected to come due.

The plan outlined by DBL officials called for reductions in fixed expenses, liquidation of DBL positions in corporate equity and debt securities, consideration of exiting the commodities and mortgage-backed securities businesses, and liquidation of substantial parts of the junk bond inventory. Successful implementation of this plan, of course, hinged on DBL and GSI's ability to continue to trade with other dealers and to continue to obtain short-term financing for trading and matched-book positions. Moreover, the plan assumed that, until DBL was able to liquidate inventory positions in an amount sufficient to reduce the firm's unsecured borrowing exposure, unsecured creditors of the firms would either roll over short-terms loans as they matured or would not cause a run on the firm. DBL officials indicated that senior management of the firm would work through the weekend on this plan and would present it to DBL's executive committee on Monday, February 12.

SEC and NYSE staff reviewed holding company and broker-dealer financial information supplied by DBL. We also requested the firms to prepare detailed schedules of inventory and haircuts, daily funding needs, and the size and expected maturities of short-terms loans at the holding company and affiliates.

On Sunday, February 11, 1990, Richard Wright, Chief Financial Officer of DBL, called senior SEC and NY Fed officials at 7:00 pm to advise that, as a result of the firm's weekend review, it had determined that revised disclosures regarding Drexel's liquidity and its inability to remove additional assets from DBL were necessary in Drexel's commercial paper circular prior to selling or rolling over additional commercial paper. 12/ Mr. Wright advised that Drexel would be meeting that night and the next morning with their major lending banks to attempt to arrange approximately $400 million in back-up secured financing. This was needed because, as discussed earlier, Drexel expected to have approximately $242 million in short-term unsecured borrowing coming due by the end of the next week, and an additional $130 million coming due within the next two weeks.

In addition to meeting with its lending banks, Mr. Wright indicated that Drexel would be speaking with certain investment

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12/ It is not clear that Drexel would have been able to sell its commercial paper on February 12, even if its offering circular had not required revision.

banking firms regarding the possibility of acquiring a 20% equity interest in the firm for a nominal price together with an extension of short-term bridge financing.

In light of the gravity of this information, we consulted extensively that night with senior officials from the relevant agencies. We all were in agreement that these developments would place Drexel in grave danger. In this connection, we recognized that resulting defaults by Drexel could have profound adverse effects on the ability of DBL and GSI to carry on their ordinary trading and funding activities.

The next morning, Monday, February 12, 1990, the Treasury, the FRB, the NY Fed, and the SEC maintained close contact with each other and with senior officials of Drexel as we continuously monitored the unfolding events. Many primary dealers informed brokers' brokers in the government securities market that they would no longer be willing to trade with GSI, effectively restricting the broker-dealer and GSI from financing their inventory through repurchase transactions. Later in the day, Standard & Poors downgraded Drexel commercial paper to speculative grade, effectively ending Drexel's access to the commercial paper market. Senior Drexel officials met with their bankers, but could not reach agreement on a short-term bridge loan to the holding company for approximately $300 to $400 million. In addition, Drexel was unsuccessful in attracting any potential investors. Given Drexel's ongoing significant contingent liabilities, this result was not surprising.

As we anticipated the night before, Drexel was placed under substantial financial pressure on Monday because of its inability to obtain renewal of unsecured loans coming due on that day. In order to provide Drexel officials an opportunity to continue ongoing negotiations with their banks, the NYSE and the Commission permitted DBL to lend Drexel $31 million in the morning to prevent commercial paper payments from being dishonored in clearance. In addition, at the end of the day, the NYSE and the Commission concurred in DBL making a $7 million margin payment to the Chicago Mercantile Exchange for the benefit of DBL Trading because of DBL's underlying obligation as a clearing firm to make good on such payments.

After direct consultation with the Commission, however, the NYSE refused to allow DBL to lend in excess of an additional $100 million to Drexel at the end of the day to meet additional unsecured lending of Drexel or DBL Trading that had come due. At this point, it had become clear that Drexel was likely to be unsuccessful in its efforts to obtain either a collateralized bridge loan or a substantial equity investment, and that there was no willingness on the part of any lender to continue unsecured lending to Drexel.

With nearly $400 million in loans to the parent company coming due or subject to being called in the ensuing days, and with less than $300 million in remaining excess net capital in DBL, it was clear that we had a choice of allowing DBL's excess capital to be exhausted in order to avoid a default by the parent company for another 24-48 hours or to protect DBL's capital and to allow Drexel and its unregulated affiliates to default. Without hesitation, we chose to ensure the ability of DBL to effect an orderly wind down, protecting the more than 30,000 customer accounts, with $5 billion in customer property.

By maintaining the regulated broker-dealer's solvency, we also were able to protect other broker-dealers and their customers from defaults on trades involving billions of dollars in securities. A sudden collapse of a major broker-dealer such as DBL could have had extremely adverse consequences on confidence in the marketplace, and on the smooth functioning of our clearance and settlement system.

On the evening of February 12, 1990, we and staff of the NYSE maintained continuous contacts with Drexel, DBL and GSI. In addition, consultations with the other government regulators continued. As a result of those conversations, we advised Drexel of our concern over the solvency of Drexel and the resultant exposures to DBL and GSI.

On the morning of February 13, 1990, Mr. Joseph called to advise that Drexel was inclined to seek relief under Chapter 11 of the federal bankruptcy code because of the holding company's inability to pay its maturing obligations. 13/ At approximately 11:00 am, Drexel issued a statement announcing its default on approximately $100 million of loans, and that its Board of Directors would meet to consider whether to seek relief under the federal bankruptcy laws for the holding company and certain of its subsidiaries, excluding the registered broker-dealer and the government securities dealer -- DBL and GSI. With respect to GSI, Drexel announced its intention to engage in an orderly liquidation of its positions.

Drexel's announcement, not surprisingly, contributed to initial uncertainty in the relevant sectors of the securities markets. Junk bond prices declined. For example, R.H. Macy & Co.'s 14 1/2 1988 senior subordinated debentures were reported trading off as much as 3 points at 81, and one RJR Nabisco Inc. pay-in-kind bond was off 3 1/2 points. Following release of the Drexel announcement, the Dow Jones Industrial Average declined approximately 25 points.

13/ As a result of this conversation, the Commission advised DBL that it should not engage in either specialist or trading activities in DBL's name pending release of the holding company's announcement. Those restrictions were lifted after the statement was issued.

News reports indicated widespread rumors that a dozen dealers in mortgage-backed securities refused to deal with Drexel through the six inter-dealer brokers, and that an estimated 30 of the 44 U.S. primary dealers had stopped trading with Drexel. Similar rumors emanated from the foreign exchange and commodities markets.

To stem concerns about the financial solvency of the registered broker-dealer, the Commission issued a statement that the SEC and the NYSE had been carefully monitoring the liquidity of Drexel and DBL, that financial information provided by DBL indicated that the registered broker-dealer had positive net worth and remained in capital compliance, and that both the SEC and NYSE currently had examination teams on the premises of DBL. Our statement also advised the market that, in cooperation with the NYSE, transfers of net capital of the broker-dealer to its parent corporation had been prohibited without specific prior approval. Simultaneously, the NY Fed issued a statement emphasizing that GSI remained a primary dealer in good standing in the government securities market.

The NYSE, after direct consultation with the Commission, directed DBL to increase, by 4%, its haircut on its junk bond inventory of $884.33 million from 31% to 35%. Pursuant to authority under NYSE rule 326, the NYSE also directed DBL to maintain minimum net capital of $150 million (after required haircuts), and prohibited advances to Drexel or its affiliates if the result of the advances would be to reduce DBL's net capital below $225 million.

Throughout the day, we consulted with the Treasury, FRB, NY Fed, Commodity Futures Trading Commission ("CFTC"), national securities exchanges, clearing agencies and other governmental and regulatory officials. SEC staff monitored DBL's settlements at clearing agencies throughout the day and into the night. While delays occurred, DBL and GSI met their payment obligations to securities, commodities and options clearing corporations. DBL continued to have available to it substantial secured short-term bank loans.

As the markets closed, junk bond prices for the highest-tier issues recovered substantially. For example, R.H. Macy & Co.'s 14 1/2 1988 senior subordinated debentures were reported trading up approximately 1/2 point, and one RJR Nabisco Inc. pay-in-kind bond was up 1 7/8 to close at off 3 1/2 points. The market for lower-tier junk issues, however, remained depressed. The Dow Jones Industrial Average closed up 4.96 at 2,624.10. After the markets closed, Drexel filed for Chapter 11 protection from creditors, listing total assets of $3.698 billion and liabilities of $2.885 billion.

V. EVENTS AFTER THE DREXEL DEFAULT

Following the holding company's default and filing for protection under Chapter 11 of the federal bankruptcy laws, the SEC concentrated its efforts in two areas. The first was to facilitate the orderly liquidation of DBL's positions consistent with protecting public investors. The second was to pursue the prompt transfer to other broker-dealers of DBL's approximately 30,000 accounts that contained as much as $5 billion in cash and securities. As an essential part of these efforts, we worked with banks, clearing agencies, securities firms, other government agencies, and other interested parties to reduce settlement logjams and to avoid financial gridlock.

A. LIQUIDATION OF DREXEL POSITIONS

During the ensuing two weeks, DBL liquidated a large percentage of its inventory and matched book positions, including the sale of its entire mortgage-backed securities position and a substantial part of its high-grade corporate debt inventory. That liquidation is not yet completed. In addition, GSI effectively liquidated its entire inventory of government securities.

Of central importance, DBL's liquidations to date have substantially eliminated any threat from Drexel's default to the structural integrity of the United States securities and financial markets. Nevertheless, that liquidation faced significant obstacles. In particular, the liquidation of DBL's multi-billion dollar securities portfolio during the ensuing ten days was hampered by three factors:

> DBL was required to surrender excess collateral to bank lenders and control of that collateral on an intra-day and overnight basis;

> DBL was unable to conduct business under routine business conventions; and

> DBL's counterparties were unwilling to deal with it.

The result of these factors was a serious logjam in the settlement of DBL transactions. The holding company's insolvency appears to have shattered the trust and confidence of the dealer and banking community in the subsidiary broker-dealer, even though it remained solvent with considerable excess liquid assets.

This problem is understandable, since no counterparty to a trade with DBL wished to risk the possibility of an insolvency before the settlement process could be completed. Irrespective of the reasons, however, the conduct of this liquidation demonstrates the impact that the bankruptcy of a holding company or holding company affiliates will have, as a practical matter, on the continued viability of a broker-dealer subsidiary. It also demonstrates, however, that it is possible to allow the non-regulated parts of a holding company to enter bankruptcy and still protect the stability of the trading system by vigorous action to protect the customers and operations of the broker-dealer.

Major issues in the conduct of the phased-windup of DBL's activities have included some of the following:

1. Surrender of collateral and control of securities.

With the bulk of its inventory pledged to banks, DBL needed the release of its collateral in order to be able to deliver securities and generate cash. Under normal circumstances, banks extend credit to dealers by accepting a list of collateral that the dealer prepares and represents is segregated on its books. This process is often referred to as an "agreement to pledge." Because the dealer retains possession of the collateral, the dealer can readily deliver the securities the next day to pay down the bank loan.

Although New York's Commercial Code has been amended to give lenders clear rights in the collateral represented in "agreement to pledge" loans, uncertainty concerning the effectiveness of those rights and whether the securities were segregated on DBL's books apparently were two factors in the decision by DBL's lenders to require the recording of their interests in the collateral through DTC's pledge program. This took control of DBL's inventory away from DBL and impeded DBL's ability to settle liquidation trades. In addition, many banks became concerned over the valuation and liquidity of DBL's junk bond portfolio, which was one portion of the collateral securing their loans. This led many of the banks to be unwilling to release any collateral to complete DBL liquidating transactions for fear that the replacement collateral would have an increasing concentration of junk bonds.

While some of DBL's lenders initially agreed to release securities to DBL's control, thereby permitting DBL to deliver those securities to purchasers and use the resulting cash to pay off liabilities, as the week progressed, DBL's lenders generally became unwilling to release collateral during the day. This development caused extreme difficulties in settling DBL's liquidating transactions.

On February 15, 1990, DBL management began discussions with its more than ten bank lenders to liquidate the securities they held as collateral for short-term loans. As a result of protracted negotiations monitored carefully by SEC, NY Fed and

NYSE staff, an agreement was finally reached on Monday, February 19, 1990, to permit the settlement of approximately $260 million of DBL's liquidation transactions, segregation of approximately $40 million in fully-paid-for customer securities, and the reduction of outstanding loans to the participating banks through the proceeds of those transactions. In connection with these settlements, the banks also agree to hold 10% of the proceeds in escrow for DBL. Those funds were earmarked for DBL's operating costs upon completion of a satisfactory plan for winding down DBL's operations.

2. Mortgage-backed Securities Settlements

Mortgage-backed securities settlements provide a second illustration of the difficulties in reducing DBL's aggregate holdings of securities. As the Committee knows, mortgage-backed securities are pools of mortgages that have been packaged for resale to investors. Mortgage-backed securities are bought and sold in both cash and forward markets. Settlement of forward market trades is especially complex, in part because mortgages pay both principal and interest on a monthly basis.

Some mortgage-backed securities, such as Federal National Mortgage Association and Federal Home Loan Mortgage Association securities, are issued exclusively in book-entry form and are transferred over Fedwire. Other securities, principally

Government National Mortgage Association ("GNMA") pass through mortgage-backed securities, are certificated instruments. Some of the GNMA securities are, and eventually all will be, eligible for deposit and book-entry settlement at the Participants Trust Company ("PTC"), the user-owned depository for certificated mortgage-backed securities. Others are still settled through exchange of physical securities.

Actively traded coupons in mortgage-backed securities, such as the GNMA 9% and 9 1/2% coupons were supposed to settle, by industry convention, once each month, in this case, February 14. These coupons, again by industry convention, do not yet settle by book-entry movements at PTC. The process for settling these trades depends on the seller delivering negotiable certificates to the buyer against payment of funds over Fedwire later that day. In the GNMA forward market, the seller must call the buyer 48 hours before the settlement date to identify the securities that will be delivered. On February 14, 1990, virtually none of DBL's $346 million in net settlement obligations to the other dealer members of the MBS Clearing Corporation, representing $3.3 billion in gross trades with these dealers, settled. Few, if any, of DBL's counterparties notified DBL on Monday what they would be delivering on Wednesday. Of those that did provide notice, few were willing to surrender securities to DBL against the promise that they would be paid later in the day. Because DBL was unable to get securities from the seller, and normal conventions do not provide for DBL to obtain funds from its counterparties without itself making delivery, DBL's ability to settle trades was essentially extinguished. 14/

These problems were largely resolved last week when DBL sold its mortgage-backed securities portfolio to Goldman Sachs in a single transaction, which closed on Friday February 23, 1990. In this one transaction, Goldman Sachs took over DBL's forward mortgage-backed securities commitments and failed settlements with over 325 consenting counterparties.

In summary, despite difficulties, enormous progress has been made in the settlement of DBL's liquidation transactions. Commission and NY Fed staff are working closely with DBL and relevant clearing agencies and financing banks to ensure that liquidation settlements will continue to occur.

14/ Similarly, DBL lacked sufficient collateral at PTC to permit GNMA securities to be delivered from its account to other dealers and banks. This problem was resolved with the help of DBL's mortgage-backed securities clearing bank, Security Pacific. Security Pacific arranged to take possession of securities pledged to it in DBL's account at PTC, and then to deliver those securities to DBL's counterparties. As a result of these arrangements, Security Pacific was able to deliver approximately $95 million in securities against payment on February 15, 1990.

B. DBL'S CUSTOMER ACCOUNTS

On February 12, 1990, DBL had approximately 30,000 customer accounts. Many of these accounts were cash accounts for institutional customers to whom DBL owed securities or funds in connection with open trades. Most of these trades settled during the last three weeks. In addition, approximately 500 of these accounts were transferred to Goldman Sachs as a result of DBL's sale of its mortgage-backed securities positions.

When it determined to liquidate, DBL initially moved to transfer its cash and margin accounts to Smith Barney, Harris Upham & Co. Incorporated. However, when certain difficulties could not be resolved, the NYSE solicited other member firms regarding the accounts. Approximately 5,500 accounts were taken over by Shearson Lehman Hutton Inc.; approximately 2,500 IRA accounts were transferred to the Bank of New York; and approximately 1,100 accounts that were introduced to DBL on a fully-disclosed basis by Burnham Securities Company were transferred to Wertheim Securities. Finally, a group of accounts of foreign customers were taken over by Kidder, Peabody & Co. Incorporated. Despite the haste and the number of positions involved, the firms experienced no serious technical problems in delivering and receiving the accounts.

As of today, DBL still carries approximately 530 margin accounts, which were rejected by Shearson either because the account did not meet its margin standards or because DBL could not immediately deliver all of the securities in the account. All but 284 of these accounts, having a value of about $20 million, are expected to be transferred shortly to Shearson, Smith Barney or Kidder Peabody.

In addition, DBL is carrying about 4,700 cash accounts. Approximately 400 accounts are for beneficial owners of junk bond securities in the form of master certificates that are not registered with the Commission under the Securities Act of 1933. DBL has informed us that it intends to send the certificates to the appropriate transfer agents to transfer the items into customer names.

Further, there are approximately 130 accounts that contain worthless securities and a substantial number of employee accounts that contain Drexel stock. There are a number of other accounts that will be transferred to other firms within a week.

DBL has assured us that by the end of next week, each customer account will be transferred or otherwise provided for, except for some margin accounts having a value of some $20 million and some cash accounts that contain Drexel stock or other securities with legal transfer problems. Those accounts will be asked to pay off their indebtedness to DBL or give instructions for transfer of their assets. There are also still a number of "receipt versus delivery" customers remaining on DBL's books, which will be satisfied when DBL delivers the securities to the customer against payment for those securities. Finally, DBL is holding approximately $75 million in suspense accounts, which may be customer-related liabilities. We expect to continue to work with DBL and NYSE officials regarding the appropriate disposition of those monies.

During the account transfer process, most of DBL's customer's commodity futures accounts were transferred to other firms or were liquidated without great difficulty. There are still about 38 customer accounts at DBL, of which ten are U.S. customers. Constant inspections throughout the period showed DBL was always in compliance with CFTC customer segregation requirements. Aggregate worldwide commodities positions of all the Drexel entities were most likely in the billions of dollars at the time of Drexel's insolvency filing.

VI. IMPLICATIONS OF THE DREXEL INSOLVENCY

The events described above underscore the need for the Commission to have regular information regarding a broker-dealer's holding company and related corporate organizations. The Commission did not have adequate information regarding the

Drexel holding company and its unregulated affiliates. The absence of that information severely hindered the Commission in its monitoring of the regulated entities, especially our ability to know of the imminence of a liquidity crisis for the parent, and the corresponding risk that the broker-dealer's capital could have been depleted in a desperate but fruitless attempt to pay the parent firm's unsecured creditors.

We believe that in order for the Commission to better understand and anticipate problems in broker-dealers, we must have information on how broker-dealer holding companies and their related entities fund their operations, allocate their capital, and manage risks inherent in their businesses. Because this information is so critical to our ability to monitor broker-dealers, I urge the Senate to promptly pass the risk assessment legislation that the Commission has proposed. I do not believe that our system, and the tens of millions of public shareholders, should be exposed to sudden risk of loss due to hidden problems in a controlling and unregulated entity.

We believe that our current net capital rule is generally sound. Nevertheless, I have asked the Commission staff to commence an immediate review of the rule in light of our experiences in this situation. Capital is the critical element in achieving systemic stability, and we will propose any regulatory or legislative modification we determine may be necessary to ensure capital adequacy.

Finally, the clearance and settlement system deserves immediate attention. As you know, one title of the Market Reform Act would authorize the Commission to create national rules where necessary to create an efficient and effective clearance system. Swift and reliable procedures for clearing transactions in all types of portfolio instruments are vital to the ability to reduce the size of a failing firm in an orderly manner. The Commission strongly supports this legislation, as well as ongoing efforts to achieve worldwide improvements in clearance and settlement systems.

VII. CONCLUSION

In conclusion, the SEC has worked closely with the FRB, NY Fed, Treasury, CFTC and the NYSE to ensure an orderly liquidation of DBL and GSI. To date, substantial progress has occurred without exposing the securities markets to undue systemic risk. Nevertheless, Drexel's insolvency underlines the critical importance of providing the SEC with increased access to information regarding the financial activities, funding, and inventory of broker-dealer holding companies. Accordingly, passage of the Market Reform Act is critical to effective financial oversight of the securities markets.

Most importantly, the failure of Drexel, a $28 billion institution, has so far occurred without direct cost to the American taxpayer. Public investors and others who dealt with the regulated broker-dealer subsidiary have been protected, and the public has not been called upon to pay the creditors of DBL's unregulated affiliates.

The **Chairman**. Thank you very much, Chairman Breeden.

Let me now call on other members that have come in for any opening comments they wish to make. In the order of arrival, let me now call on Senator Bryan.

Senator **Bryan**. Mr. Chairman, I do not have a statement.

The **Chairman**. Very good.

Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator **Gramm**. Mr. Chairman, let me say first that, Richard, I think you have done an outstanding job on the Drexel case. I think the performance of the SEC in the past has not been exemplorary in many cases, but I think your performance in this area has been outstanding, and I think the public has been a beneficiary.

Once language is set, it is hard to get the public to change the language, but it still pains me to hear the term "junk bond." If I were entrusted to be the regulator in these important financial areas, I would not succumb to the temptation to call a financial instrument that is the lifeblood of small, medium-sized and independent businesses "junk bonds."

The only junk bonds I'm aware of are the bonds issued by the Federal Treasury. In fact, if we did not have the ability to tax or print money, my guess is that our bonds would not sell.

Finally, let me say, Mr. Chairman, that I think the fact that a big firm failed, that no taxpayer money was lost, that the market was not substantially destabilized, are indicators that not only did the SEC do its job, but that the markets worked. I think that if you recognize that Drexel's failure was due in large part to a couple of major events. A $650 million insider trading penalty imposed because of illegal behavior as well as the change in law prohibiting savings and loans from holding high-yield bonds as assets probably more than anything else sent Drexel under. Drexel's failure says nothing about the market viability or the investment soundness of high yield bonds.

Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Gramm.

Senator Shelby.

OPENING COMMENTS OF SENATOR SHELBY

Senator **Shelby**. Thank you, Mr. Chairman.

Mr. Chairman, I have an article from the Washington Post, dated February 28, 1990, by Robert Samuelson, I'd like to be made part of the record and note that—a lot of you read the article. He made several valid points, I believe, the most important of which is that high-yield bonds are merely a tool of finance and not in themselves bad, in spite of the turbulence in the market.

I think many of us would still argue, as Senator Gramm just mentioned, that they are for smaller or medium-size companies access to capital and we should never forget that. And if something is bad, as the term is used, perhaps it's the way in which the bonds were often used to finance monolithic buyouts and takeovers that had little merit from an economic perspective.

Mr. Chairman, I would like for this article to be part of the record.

The CHAIRMAN. Without objection.

[The article referred to follows:]

Robert J. Samuelson

The Good Drexel Did

Despite excesses, the junk-bond investment bank was still a positive force in the economy.

The downfall of Drexel Burnham Lambert—the Wall Street firm that pioneered "junk" bonds—has been greeted with loud hoots of approval of the sort rarely heard when a major business fails. The verdict has been simple: Drexel got what it deserved. The obituaries are often spiteful in tone and remind me of a crowd cheering at a public hanging. The reaction is understandable, but it creates a misleading epilogue to the Drexel story.

Granting that deal-making went to excess, I submit that Drexel still represented a positive force for the U.S. economy. Drexel helped force corporate managers to run more productive and profitable companies. This, of course, was not Drexel's aim, which was to enrich itself. But this streamlining was the result, and it has been minimized in most post mortems.

The message simply doesn't fit popular prejudices. In the 1980s, Wall Street investment bankers became cult villains. They were an army of Gordon Gekkos chanting the glories of greed and collecting huge fees. In 1987 Michael Milken, who built Drexel's junk-bond empire, was paid $550 million. Even Drexel's average bond traders and stock analysts, now unemployed, earned salaries well into six figures. People so lavishly compensated inspire envy, not sympathy.

We "knew" that something must be fishy, and by gosh, Drexel's collapse proved it. Lost in all this self-righteousness is any appreciation that Drexel's activities might have had larger benefits. By this, I do not merely mean that Drexel helped finance many productive companies (MCI and Turner Broadcasting among them). Nor do I mean that the good of hostile takeovers or leveraged buyouts that it financed outweighed the bad of deals that were poorly conceived or ended in bankruptcy.

Drexel's main contribution was more subtle. It created a mechanism to take over companies against their will: namely, buying their stock with funds raised through the sale of junk bonds. In so doing, Drexel stimulated countless executives to overhaul their firms. The fear was that if they didn't, someone else might. Corporate vocabulary changed. Chief executives started talking of "creating shareholder value" and making their business "more focused." Highly diversified conglomerates sold off divisions. Companies slimmed overstaffed bureaucracies.

The most powerful form of competition, the economist Joseph Schumpeter once wrote, "is merely an ever-present threat. It disciplines before it attacks." This was the type of discipline unleashed on Corporate America. It was potent. In a study of major companies, economist Frank Lichtenberg of Columbia University reports a dramatic "de-diversification." Between 1985 and 1989, the number of different industries in which companies operated dropped by 14 percent. Meanwhile, the share of companies in only one industry jumped from 17 to 25 percent.

Some check on executives' power is vital. Of course, all companies face other competitors that may undercut them on price, offer a better product or introduce a superior technology. There are also the pressures of economic downturns, which squeeze profits and tighten credit. But these disciplines often don't suffice. Companies can still get sloppy or too diversified, and—without the threat of executives being ousted—not much can be done about it. In theory, a company's outside directors should police its top executives. But the directors don't have the time or inclination, as a study by Jay Lorsch and Elizabeth MacIver of the Harvard Business School shows. Indeed, 63 percent of outside directors are chief executives of other companies and are apt to sympathize with management.

Big shareholders, mostly pension funds, are another possible check. In 1988, pension funds owned 21 percent of the $3.6 trillion of stock. Again, the check is illusory. Corporate pension-fund managers don't criticize other corporations. Pensions of state and local government are freer. But they can't easily monitor, let alone influence, hundreds of companies. When two big public pension funds recently requested that General Motors consult them about the company's next chief executive, GM's response was curt: forget it.

The threat of a takeover, however distant, substituted for these more explicit controls on management. The threat is now vanishing. Partly, this is a desirable and temporary reaction to runaway speculation. Deals came to involve too much debt and extravagant purchase prices. Bankruptcies resulted. Not all of this was Drexel's doing. Campeau Corp.'s takeover of now bankrupt Federated Department Stores was handled by First Boston. But Drexel and Milken set the market's aggressive tone and suffered its consequences. Bankruptcies depressed junk-bond prices, and as Drexel's junk-bond portfolio dropped in value, so did the company's chances of survival. The $650 million fine levied on Drexel—excessive, in my view—for securities-laws violations made it especially vulnerable to setbacks.

In isolation, none of this would permanently immunize companies against unwanted takeovers. There would simply be more caution in the future. Good. But in fact, Corporate America has skillfully exploited the anti-takeover mood to insulate itself. Anti-takeover laws have passed in 39 states. In practice, these restrict only takeovers opposed by managers. Federal legislation may follow in the wake of Drexel's collapse. The truth is that most top executives believe in a divine right of management. They don't want outside interference. When they talk of the "long term," they really mean their own independence and job security.

It's hard to cheer these developments. What's good for executives is not necessarily good for business or good for America. In the 1960s and 1970s, managerial power was virtually unassailable. The result was that many companies became flabby, leaving them exposed to the tougher times and competition of the 1980s. Drexel's demise may now lead to a new rise in management's power. Like everyone else, executives do a bit better when they know someone is looking over their shoulders. Corporate America needs to be held accountable for its performance. And if Drexel's disappearance makes it less accountable, we will all ultimately be the losers.

The CHAIRMAN. Thank you, Senator Shelby.

Senator Pressler.

OPENING COMMENTS OF SENATOR PRESSLER

Senator PRESSLER. Thank you, Mr. Chairman.

I do have a brief opening statement. I would also say that I think here in this hearing I hope to hear what we can do to make the issuance of debt instruments less attractive in corporate financing. Is there a way it might be done on a revenue-neutral basis without loading up our budget deficit?

Also, Mr. Chairman, I think we need to find—and I would like to hear the witness respond to what is the status of the millions that Drexel owes the United States and does it come ahead of other debt in the chapter XI proceedings?

Those are the things I will be listening for. I have to attend another committee hearing later this morning but I will try to get back to ask some questions. But I think those are some issues that are foremost in my mind that we need to address.

The CHAIRMAN. Thank you, Senator Pressler.

Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you very much, Mr. Chairman.

Chairman Breeden, thank you for being here You mentioned in your testimony you wish you had known earlier about the movement of the capital to the parent and would ask the question, is this information that you were precluded from receiving? Does the law have to get changed? Do procedures have to get changed?

Clearly, information is one of the most important parts of regulating this marketplace. I know you are a strong regulator and we've had a very strong tradition at the SEC of regulation. I think that's one issue very specific to this that gets raised.

I think a second one goes back to the report of Secretary Brady. If we are looking at problems in the high-yield bond market, what problems are we going to be anticipating that might pop up in other marketplaces, particularly those over which you have jurisdiction or partial jurisdiction?

One of the troubling issues which we saw a flap on 18 months ago or so is the Chicago markets and the relationship of the SEC and the New York markets to the CFTC and the Chicago markets. Secretary Brady had, as we all know, recommended the rationalizing of the markets and rationalizing or structuring the regulatory approach so that which is a security is a security and it is regulated by you, but then we backed off of that. Should we be again examining the Chicago marketplace and a tougher regulatory structure so that we can perhaps surround that and not be faced with an S&L crisis and not be faced with the lack of information that you were mentioning this morning?

It seems to me that is a broader set of issues. I know it's not central to today's focus, but in fact I think it's probably a function of today's hearing.

Mr. Breeden, thank you very much.

Mr. Chairman, thank you.

The CHAIRMAN. Thank you, Senator Wirth. There are a number of important issues that you put on the table there.

Senator Bond.

OPENING STATEMENT OF SENATOR BOND

Senator BOND. Thank you, Mr. Chairman.

I would simply second some of the things said by Senator Shelby and Senator Gramm. I think it's very important to recognize the positive influence and the benefits that came from some of the activities of Drexel and the Samuelson article does note that well.

I further would follow up on Senator Gramm's point, that many, many small businesses in my State have to issue debt certificates——

Senator GRAMM. High-yield bonds.

Senator BOND [continuing]. Which are considered under the opprobrium which you stated. Having said that, that does not in any way lessen the judgments which have been made about certain specific activities and, if nothing else, this traumatic experience which has been very disruptive to many of the individuals involved does show that the market works.

I appreciate your balanced presentation of an analysis of it. I think that as we build stronger and stronger investment banking institutions in this country we inevitably are going to see some succeed and occasionally some fail. And the ability of the system to handle those failures and move on is extremely important.

I have also noted several articles which you have probably seen which suggest a number of innovative ways in dealing with the substantial portfolios of high-yield bonds that, say, for example, may wind up in the RTC. One commentator suggest that perhaps establishment of securitization, a closed-end mutual fund type of operation, that I hope could be operated outside of Government—I never would say as a first resort that the Government ought to be into the business of packaging these, but when the question period comes, if I'm still here, I was going to ask what you see as a possibility for market-oriented solutions to some of the questions that the existence of a large number of these high-yield bonds, in the absence of what has been a traditional market-maker, to see what thoughts you may have on the opportunities there for the marketplace.

Again, Mr. Chairman, thank you for calling this hearing and it's most informative to hear what Chairman Breeden has to say.

The CHAIRMAN. Thank you, Senator Bond.

I mentioned earlier that Senator Dodd, chairman of the Securities Subcommittee, has a hearing scheduled for next Tuesday with a group of witnesses that will follow up on some of the issues that are raised today. Let me call on Senator Dodd.

Senator DODD. Mr. Chairman, I just ask unanimous consent that my opening statement be included in the record and commend you for having the hearing and I look forward to an ongoing, positive relationship with Chairman Breeden.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. Let me, first of all, commend Chairman Riegle for holding this hearing. It is absolutely imperative that we understand the reasons for the collapse of a major securities firm, which only a few years ago was the most profitable securities firm in the country.

As you may know, the Securities Subcommittee will hold a hearing next Tuesday on the condition of the securities industry more broadly, and a number of securities industry leaders will be testifying. It is a hearing we scheduled over 2 months ago, and the events of recent weeks have made it even more timely.

Chairman Riegle has laid out the major issues to be considered today. From my perspective, there are several key questions.

First, as a result of Drexel's settlement with the SEC, probably no firm in the securities industry was, or should have been, more closely monitored by regulatory officials, by independent auditors, and by outside directors. There were two former Chairmen of the SEC on its board, one of whom served as Drexel's chairman. And yet, by all accounts, its sudden failure came as a surprise to everyone. Even with its ongoing oversight, the SEC learned that Drexel was tapping the excess capital of its broker-dealer only after the Federal Reserve notified the agency. The Federal Reserve became aware of this activity as a result of its supervision of the firm's Government securities affiliate.

What does that tell us about the level of information available to the SEC with respect to Drexel—as well as for other securities holding companies? What does that tell us about the level of management supervision for Drexel—and for other firms?

Second, although there certainly are a number of profitable firms in the industry, the securities industry as a whole is in a period of "recession," as one of our witnesses next week has said. Over 40,000 jobs have been lost since October 1987, and more layoffs are in store. Profit margins for the industry as a whole are projected near historic lows. Trading activity has slumped; merger and takeover activity has declined; prices of junk bonds have plunged and bridge loans at some firms are troubled. We have seen in Drexel's case how a loss of confidence can cause a liquidity crunch—and the bankruptcy of a major firm.

What else is in store for the securities industry? Are there other firms in trouble? What is the SEC doing now, in light of the lessons of Drexel, to monitor the condition of other firms?

Finally, all of us recognize that the securities industry—which stands at the center of the capital-raising process in this country—is an industry built on risk-taking and innovation. We've written our laws to protect the customers of broker-dealers; but we've not directed the regulators to focus on the soundness of the institution itself—particularly in the case of broker-dealer holding companies. This spring, we hope to have the Senate consider the Market Reform Act, which I introduced with Senator Heinz, and which contains provisions giving the SEC authority to get information about broker-dealer holding companies. New York Federal Reserve President Gerald Corrigan, supports that measure, and suggests that there may be a need to strengthen it with specific minimum capital requirements for broker-dealer holding companies.

Does the Drexel case support the need for the Market Reform Act? Does it call for greater measures, such as the one suggested by President Corrigan?

I look forward to exploring these and other questions with our witnesses this morning.

The CHAIRMAN. I think you're seeing, with the Senate not in session today, the intense interest that we have in this issue, evidenced by the number of Senators who are attending this morning's hearing. These Senators have other activities going on and need to be in different places.

Let us start the questioning. Let me ask you, first of all, do we have other broker-dealers out there right now with capital problems?

Mr. BREEDEN. Senator, we have continued to monitor on an ongoing daily basis the capital positions of broker-dealers throughout the system. Where we had a firm in trouble, we would take action, as we did in this case. We do not have firms that are not in capital compliance that are continuing to operate.

The situation, which we are all familiar with and when has existed in other industries where firms not in capital compliance continue to operate does not exist in the securities market.

The CHAIRMAN. Now from what I read and am told, you are seeing an enormous amount of shrinkage in the brokerage business at the moment, a lot of layoffs, and we see stories about questions of whether there's sufficient capital and in some cases where capital is now being put in.

In terms of the problems that were there, do you have an understanding of what was going on in the affiliate in the case of Drexel? Do you feel fully up to speed in terms of what's going on in the affiliates of any other broker-dealer that is out there today?

Mr. BREEDEN. Senator, as you know, the authority to compel information regarding parent holding companies and other affiliates does not now exist. We do get pretty good voluntary cooperation from many of the firms. We do regularly, as does the New York Stock Exchange, try to review the overall picture.

But I would not be able to give you a guarantee that we know everything that's going on in the unregulated affiliates of broker-dealers. That simply is beyond the scope of our current authority and what we normally examine and consider.

What I can tell you is that the broker-dealers of all those firms are adequately capitalized, and we review that capital level. We are very careful to make sure that no broker-dealer would continue in operation, irrespective of the condition of its parent holding company and affiliates, if it didn't fully comply with the rules we have to protect the market itself and the customers of those firms.

The CHAIRMAN. But I heard you say earlier, if I remember the number, $300 million moved out of the broker-dealer into the affiliate in a very short period of time that you were not aware of. You found out after the fact.

I'm wondering, could that kind of situation be going on anywhere else right now?

Mr. Breeden. If a firm has what we call excess capital, capital in the broker-dealer that is beyond what it is required to have, the firm is legally free to move that capital elsewhere within the organization. It is beyond the requirements of what they are required to maintain. As they get close to the minimum, they are required to notify both the exchange and ourselves.

So that if a firm had capital above its minimum but also above the warning levels, it is not required today to give us prior notification of transfers. So I can't tell you that no firm has moved any portion of its capital.

What we seem to be seeing is the major firms putting capital into their broker-dealers, not taking it out. So I think the trend is in the other direction.

The Chairman. But even that I think is an important fact. If they are putting it in, why are they putting it in?

Mr. Breeden. Well, I think the decision of any firm to——

The Chairman. But if you see a pattern where capital is being placed in subsidiary broker-dealers, it suggests that there's a reason for it. I'm wondering what that reason might be.

Mr. Breeden. Well, I want to be careful that I don't misstate here and characterize it as a pattern, a widespread pattern, but to the extent we have seen significant movements in the last few weeks, it's been significant movements of capital into the firms rather than out of them. I wouldn't want to suggest that every firm has been doing that. There are a great many firms. I would be happy to supply the committee with a list of the capital position of those firms. The firms have, in most cases, very strong capital positions and——

The Chairman. We are concerned about anybody that's sort of the exception to that general situation. If we had any other major companies that were in a situation where it looked like there was a capital shortage and there might be this same type problem between the dealer and the affiliate, you say you can ask for information voluntarily—are you doing that in each case and are you getting full voluntary compliance?

Mr. Breeden. We have been making requests of the firms for more data about their holding company and affiliates. I'm not aware of any instances of being refused the information that we have sought. I plan to continue asking on a voluntary basis for information from the parent holding companies about any material financial risk that exists in their structures and I would hope that voluntary compliance would continue to occur.

We also have been working with the New York Stock Exchange. They are in the process of notifying members as to revisions in some of their procedures to require prior notification of capital movements and while I would never want to prejudge the outcome of any rule-making proceeding—as you know, the Commission cannot change its own rules without formal proceedings with public comment—I would be very surprised if our request for public comments did not include procedures for notification of at least significant movements of capital.

I don't think we would want to have a situation where every dollar that moves in or out of the brokerage has to be subject to prenotification if there's a huge buffer, but where you get very material amounts of capital moving I think we ought to be aware of that in advance.

The CHAIRMAN. Well, I'll just finish by saying if a company finds its credit rating lowered—we are seeing some examples of that now in other major companies—and it turns out to be a kind of liquidity problem such as you saw in Drexel, it looks to me as if a lot of money could be required and moved in a hurry. We apparently didn't know about it until it had happened. Fortunately, there was enough of a cushion in the end that it appears as if you're going to be able to wind down the broker-dealer without public customers apparently being damaged. At least that's the impression. One hopes that's right.

We might not be quite that lucky the next time. So I want to make sure that we really have a feel for what's happening so that we don't wake up and find that something has taken place and we're too late.

Mr. BREEDEN. Mr. Chairman, I totally agree with you. The very purpose for which the Commission has proposed the risk assessment provisions which, I think are quite mild and do not intrude on the management of holding companies and their affiliates, is to give us advance notice, advance warning. I have called them fire alarm provisions. If there's a five-alarm fire raging in the holding company or one of its affiliates, we think we ought to know about it. We think that as the regulator of the broker-dealer charged with protecting public customers that we are entitled to know about that.

I certainly appreciate the efforts of this committee in working with us to try and make that a legal requirement. I can't do anything but agree totally that this situation demonstrates a flaw in our current regulatory structure, a potential flaw. There is a possibility that there could be a serious problem of a financial nature outside of the regulated entity, that in the real world, in the real marketplace, would affect the regulated entity when it became known in the market. Credit will dry up. Pressures for moving funds out of the capital base of the firm may intensify. Temptations may exist within the overall structure of trying to shift funds that may or may not be consistent with the interest that we have in protecting that regulated subsidiary.

And I think there ought to be a higher level of oversight than there is today over those types of decisions when you get into the possibility of an imminent failure, at least at the parent level. We can do our job better if we have a little advance warning of some of these problems.

Having said that, I don't want to create concern that we can't do the job now. We did find out about the transfer of those funds long before they had depleted the capital of the broker-dealer or come anywhere close to it, and we did put a stop to the transfers. So just as we acted in that case, I can assure you that if that situation were presented tomorrow we would act the same way again and I am confident that we can do the job under the current structure of the law. The market is safe. This situation shows the great strength and resiliency of our regulatory system. I think we can make it better, but the situation today is one in which we are prepared to act and act vigorously where we have to.

The CHAIRMAN. Well, we are going to follow through. We reported that legislation out of the committee. It ought to be on the Senate floor in 3 weeks or so. We've got to get it enacted to correct these flaws.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Chairman Breeden, touch on, if you will, and share with me and those here this problem of double leveraging and would you conclude by giving me your opinion as to whether or not this technique might provide the kind of market and stability that will exacerbate a problem, whether it be Drexel or anyone else? Is there a need for any regulation as it relates to that?

Mr. BREEDEN. Well, Senator, the question of the so-called double leverage is a serious one. It's one that affects not only holding companies in the securities business but also in the banking business and really in any financial activity.

We require capital in specified amounts to be in the regulated broker-dealer, as you know. The market, as a practical matter, also requires capital to be there. The participants in trades with a firm want to know that that firm is going to be solvent enough to make good on its obligations.

And we do not now have requirements that deal with the source of that capital. So long as, for purposes of its use in the broker-dealer it is unencumbered and available to pay the obligations and the liabilities of the broker-dealer, that is sufficient for our purposes for its inclusion in capital.

Now where there is a controlling parent organization of a brokerage firm, that organization derives the capital that it invests in its subsidiary in a variety of ways. It may go to the market and offer its own equity securities, raise equity capital, and then invest that capital in its subsidiary. It may simply choose to reinvest net income—profits that it has generated—downstream rather than paying them out as dividends. Or in some cases, it may also borrow some of those funds; and therein is created what we refer to as double leverage. Because the funds that are treated as equity in a subsidiary are then leveraged through borrowings at that level of the corporate enterprise, if they are in fact the fruits of borrowing at the parent level, then you obviously have less aggregate strength than if at the parent level those were net profits or equity investments.

We do not now regulate the source of investments in the capital of broker-dealers. To do so would head down the road of consolidated capital standards which, as you know, exists in the bank holding company area. The Fed does set an overall consolidated capital level and does take a look at the mix of capital, sources of capital. We have not traditionally found it necessary to do so in the securities industry, but certainly the question of the dependence of a firm on earnings to be upstreamed from the subsidiary in order to pay debt at the parent holding company level is relevant to the real world's evaluation of the strength of one of these companies.

Analysis of that situation is what prompted the rating agencies to take the action they did in the Drexel case because of their concern about the level of the pressure on the parent to satisfy its debt.

So these questions are serious and double leverage does go to the effective stability of firms.

Senator D'AMATO. Well, Mr. Chairman, I might suggest that it may behoove this committee to ask that a study at least be undertaken by the Commission. I don't know what they are doing as it relates to that now. Give us a report in 30 days or so as to what they think because this is just going to be speculative or what should or shouldn't or is it proper, et cetera. I think you should at least have the ability to follow and to know what the source of these funds are. If they are highly leveraged in the manner in which they may or may not be, they could create some very real problems.

I would ask you to consider that and to the chairman of the Subcommittee on Securities, I think it's an issue that we might find repeating itself or a problem that may repeat itself in other areas.

The CHAIRMAN. I think that's an important suggestion. Let's consider and discuss it. We may want that and other things. So let's consider it.

Senator D'AMATO. I have to share some concern. I read these articles where Senator D'Amato, Senator Gramm, some others say, "Wait a minute, should we rush in and just tar all noninvestment grade instruments or bonds in the private sector with the bad brush of calling them junk bonds." And for the record, I understand there are only 700 to 800 companies that can yield so-called investment grade bonds. Is that true?

Mr. BREEDEN. That's the right order of magnitude.

Senator D'AMATO. OK. All of the others which would involve in terms of capital, in terms of the financial strength of this country, much more than those 700 firms. They represent billions and billions more in assets and they have to issue, if they are going to do financing on their own, high-yield instruments. Is that true or not?

Mr. BREEDEN. Senator, first of all, I would be very happy to accept in response to your comments and those of Senator Gramm a revision in my statement to substitute the term "high-yield security" wherever I used the word "junk."

Senator D'AMATO. Look, we've got this thing sensationalized to the point that if there is an instrument that is a high-yield instrument it's used in the pejorative of "junk" and junk is bad and if anybody has ever suggested to take a look at the utilization of this, it is a terrible thing. Then you take into account that junk finance was a technique, in so many of the LBO's, which is an entirely different subject. My gosh, you've said now we get into the question of thrifts. Talk about exacerbating the problem. When we, the Congress of the United States, passed FIRREA legislation it forced—forced—the thrifts to sell these bonds, even if they're good, if they've been reporting good earnings, good interest, good income to those thrifts, if we didn't exacerbate this situation in the market by that action I don't know what did.

It's one thing for the regulator to say to a company that's poorly run that's buying truly high-yield instruments that are bad by any standard that shouldn't be purchased, "Hey, you shouldn't be doing this." But to just simply force people because they have a portion of their portfolio that's giving good returns, earning money, and say you've got to get rid of that and get your capital requirement up, I have to tell you something, we certainly did exacerbate this problem.

I don't know if you want to comment. That's your expertise. Do you think we helped out by forcing institutions to sell when you have this controversy going on, when you do have problems in this market? Does that make it more stable or unstable?

Mr. **Breeden**. Senator, to try and briefly tick off some quick answers, first of all, I would suggest you are certainly correct. If we called these securities long-term commercial paper it wouldn't have the connotation that some people put on the current—and I won't repeat the use of the term that's often used to describe it.

I personally think that the action of the Congress in dealing with the eligibility of these securities to be investments of thrift institutions was the correct thing to do, not because there's anything wrong with the securities themselves or with the yield of the securities. You have to remember, as I know you are sensitive to and every member of this committee is, that the funds that were being used to make those investments were federally insured and backed by the American taxpayers.

Senator D'**Amato**. You're preaching to the wrong guy. There were only two guys who voted against even allowing financial institutions into that, and one was me. I don't think we should ever have allowed it, but once you do open the door, then to slam it the way we did and create this situation—you've got them entrapped. You're absolutely right. That gets to the whole question of the banking business and firewalls and seeing to it that you don't have FDIC Federal deposit insured dollars going outside of the scope of guaranteeing the depositors' money, but that's a whole other thing. You're right there, but we're mixing and matching. You're allowing these guys to do all these other kinds of things. We opened the door. Once we said go ahead and get into all these other activities.

Mr. **Breeden**. In the time I have available to answer you, we won't go through the whole thrift situation, but I would like to just briefly say that the problem in this case was not that there's anything wrong with these securities or with the business of high-yield securities. They do represent very important financing alternatives for a great many companies across this country. In many cases they are less expensive for the borrower or the issuer of those securities than a comparable bank loan would be. And to the degree that the cost of that capital is lower, it helps to promote the efficiency and competitiveness of the user in acquiring or building plant and equipment and generating jobs. So I agree with you on that.

The problem in this case was not anything dealing with whether high yield securities are good or bad, but whether it's safe or unsafe for a financial institution to have a portfolio in which they have overnight liabilities invested in long-term securities which in this case became illiquid. We've seen that borrowing short and lending long caused the failure of bank after bank, after bank, and it helped cause the failure of Drexel Burnham.

The **Chairman**. I might just say before yielding to Senator Bryan that there were some differences of opinion on that, but I agree very much with the Chairman of the SEC that it was essential, at least in the view of this Senator, that junk bonds or high-yield securities not be part of the investment practices of savings and loans and so we did change that in the legislation and I think they have a role to play in the society as a whole if people want to do that with non-Government-insured money. That's a different story. But I think when it crosses the line I think that's a different issue and there is a difference of opinion on the committee and you may get more of the flavor of that. Nevertheless, we've taken that action and I think it's a constructive one.

Senator Bryan.

Senator **Bryan**. Thank you very much, Mr. Chairman.

Mr. Breeden, I have a couple of questions that were prompted by your prepared testimony.

You talked about the movement of capital surplus as you called it to the unregulated affiliate and that you would like to have had access to that information or known about it in a more timely fashion.

The question that I have, is there a regulatory impediment? Is there a lack of statutory authority on your part? What needs to be done from your perspective from the Congress, if anything, to provide you access to that information?

Mr. **Breeden**. Senator, as I mentioned, we are engaged at this very moment in an analysis of our current statutory authority in the capital area. I think we probably do have ample authority to require much greater advance notice than we currently require regarding contemplated capital changes, and we are going to look first at proposing changes to strengthen our system within the current legal authority.

That, coupled with the passage of the Market Reform Act, which would give us the vital early warning of problems when they are headed in our direction, would, I think, give us what we need.

Senator **Bryan**. Could you give us some time line as to how long the internal review by the agency will take as you examine your authority and you can report back to the chairman and the members of this committee what additional authority you feel that you need, if any, or at least your overall evaluation as to your operating capability from a legal authorization perspective?

Mr. **Breeden**. Certainly.

Senator **Bryan**. Let me ask you a couple of specific questions about the Drexel deal.

It was reported that a relatively few weeks before the filing of the petition in the bankruptcy court that some $206 million in bonuses were paid out to employees. Is that information accurate? If so, is there any ability that the bankruptcy court might have to reclaim any of that money for the benefit of creditors?

Mr. **Breeden**. Senator, it is true that there were substantial payments of bonuses at year end. That is a traditional practice in the securities industry at the conclusion of the year.

As soon as we became aware in this situation of the payment of those bonuses within such a close period of time to the insolvency of the company, I directed an immediate examination of the bonuses that were paid, who received the funds, who authorized the payment, and what the authority was. We have to find out, for example, whether some of the payments may have been the result of preexisting plans with a formula for compensation that does not involve any improper practice or suggestion of it. I simply don't know the facts yet—there may have been discretionary payments that weren't required. So we are in the process of gathering the information on who got the bonuses and who authorized them to be paid. If there were decisions made in contemplation of bankruptcy to deplete the assets of the firm by payments to insiders, then it is possible the bankruptcy court will take some action about that and it's possible we will take some action.

Senator **Bryan**. So you haven't signed off on that. I also understand that you are seeking to be appointed to the creditors committee.

Mr. **Breeden**. Not personally.

Senator **Bryan**. But as an agency?

Mr. **Breeden**. We have sought to be put on the creditors committee in a full voting capacity. We are, as you know, one of the major creditors of this organization in seeking the balance due to the disgorgement fund that was required to be established pursuant to the terms of the settlement with Drexel. There's approximately $150 million of unpaid obligations of the firm to that fund. People who may have been defrauded and should have the benefit of those funds to recompense them for their losses as a result of that fraud.

Senator **Bryan**. Looking at this from a little broader perspective, a number of members of the committee have talked about high risk investment grade bonds or noninvestment grade bonds and the functions that they have served in the marketplace.

One function of these junk bonds as they've been called serve—I think from a lot of perspective I think it's pretty hard to support—is the activity that relates to the LBO and merger activity, which from my own perspective I think has created major damage to some of our principal industrial operations and damages us in terms of our ability to compete internationally.

What percentage of the junk bonds that have been issued have been used as the vehicles to effect mergers or LBO's as opposed to the other types of activities that have been discussed here by the committee?

Mr. **Breeden**. Senator, I couldn't give you a specific breakdown of the usage of the funds. It would be very difficult to do because in any financing transaction dollars displace dollars. It would be quite a job to try to trace the proceeds of all the high-yield securities that were issued and determine what percentage have been used in acquisition transactions.

Senator **Bryan**. Do you, yourself, have any concern about the use of these type of bonds for LBO and merger purposes?

Mr. **Breeden**. Senator, the issue to me is not anything unique to the use of one type of security versus another type of security. If there are problems in connection with change of control contests in terms of the disclosures that are required or the practices that either a bidder or a target can engage in, those problems are problems we ought to look at as issues involving the takeover contest. Our view of those issues shouldn't vary based on whether the proceeds for the offering came from a bank loan versus the offer of a high-yield security.

Senator **Bryan**. It just seems, though, in the 1980's that the use of the junk bond was elevated to an art form and certainly is associated with some of the more controversial LBO's and some that have had severe financial implications for American industry and American business. When one reads and looks at these kinds of situations, oftentimes the junk bond has been the vehicle used to accomplish those LBO's and mergers.

Would you not agree that that has certainly been a widespread practice in the 1980's?

Mr. Breeden. Well, I would certainly agree that there have been widespread issuances of high yield securities and that in a number of cases the proceeds of those securities were used in connection with acquisition transactions. I think that is apparent.

I would also concur that many of the transactions may have involved higher leverage in the total transaction, the amount of equity that an issuer of high-yield securities would end up with at the conclusion of the transaction and that the degree of his leverage is something that I think the market has been correcting for some time now.

Certainly if you look at 1989 and beginning as early as June when Integrated Resources began to have difficulties with some of its obligations and later integrated and Southmark defaulted on some obligations and ultimately you had the Campeau bankruptcy filing—the market has been steadily adjusting its credit expectations. There were some deals which were very highly leveraged, and I don't think you could do those deals in today's marketplace.

Senator Bryan. Thank you, Mr. Chairman.

The Chairman. Thank you, Senator Bryan.

Senator Gramm.

Senator Gramm. Thank you, Mr. Chairman.

Richard, I think in your testimony you conclude by asking us to act on the Market Reform Act. There is an area of that bill, as you are probably aware, that was very contentious on the committee. In fact, we made a decision on the basis of one vote, with the determination to revisit it on the floor. My guess is that this area is going to make this bill very difficult to pass in the Senate.

It has to do with the SEC overriding State law. I'd like to ask you, in trying to expedite the consideration of this bill, to look at the broad range of options that the Commission could come up with that might be alternatives. Perhaps there is a procedure whereby the SEC could look at State laws and could make, even on an expedited basis, a recommendation to the Congress that Federal legislation be passed overriding these State statutes as an alternative to having a broad grant of override authority given to the Commission.

I think if we can do that, then we could come up with a compromise that everybody could support. In that case we could pass this bill through the Senate very quickly. I think failing to do that, it's going to be very difficult for us to act. I would ask you to go back and look at that language and see if there might be a possibility, with all the staff you have and all of the resources, that maybe you could come up with a proposal that would allow us to maintain the separation of powers that has served us well for over 200 years, and yet still deal with the very real problem of State statutes that limit your ability to do your job. I'd like to ask you to look at that and see if there might be some middle ground we could find.

Mr. **Breeden**. We will do that.

Senator **Gramm**. Also, I think a second problem we have is trying to keep this issue from being commingled with the battle that's going on in our sister committee in the House over program trading and the Xerox machine and the telephone, the ballpoint pen and carbon paper, because I think if we get the issue of trying to give you more power to do your job commingled with that whole issue we will never get anything done. So I would ask you also to begin to talk to people in the House. If we need the authority in this bill, even if we pass it here, unless it can be kept separate from all this other stuff, then I think we pretty well are going to get nowhere in terms of seeing it passed into law.

Mr. **Breeden**. Senator, I appreciate the suggestion and we will certainly do as you suggest in looking at the alternatives. We have tried consistently to remove what obstacles we could so that the core portions of this bill could pass as swiftly as possible.

Senator **Gramm**. I think that would be very helpful.

As I look at Drexel—and I'd like to get your opinion on it—as I look at Drexel, I think basically we have a tragedy in the sense that we had a company that was really on the leading edge of an important financial technology, a technology that has greatly benefited the country and made us more efficient, in my opinion, and has helped unleash more of the genius of the American free enterprise system, but a company that in trying to cut too many corners ended up destroying itself.

Fortunately, because of our strong system and because of effective regulation by you and by the Commission, it didn't do a whole lot of damage to the system, other than to its own employees. Do you have a similar feeling about this?

Mr. **Breeden**. I certainly share your sense of the dislocation that this situation will cause for thousands of employees that used to work for Drexel and for many of the customers. I think frankly that the customers who utilized Drexel to offer securities have in many, many cases found a number of other firms who had been trying to increase their share of participation in that market and who will step up to the financing needs that those companies may have.

But we are not unmindful of that dislocation. It is unfortunate. I don't like to see any major financial institution experience this kind of outcome. By the same token, it is our job to make sure that cutting corners doesn't go too far and we've seen some of the damage that can occur from that, too.

Senator **Gramm**. In that sense, I think this case is living proof to another company, that might be looking at that path to financial success, that this path could put you in the ditch as well as on top of the hill.

Mr. **Breeden**. I would certainly hope that would be the message that chief executives of other companies would take from this situation.

Senator **Gramm**. Mr. Chairman, I want to reiterate that I think Chairman Breeden has done an excellent job in the area of Drexel. I think the story is a good news story, and that is, that the system works, that cutting corners and cheating does not pay. And it is also the story that, if we have someone that abuses the system and tries to bend the rules and pays the price for it, our system is strong enough to withstand the disciplining process which is part of what has to be available in order to induce people to abide by the rules. So I think you're part of a good news story in a sense, while the write-ups on it are almost uniformly pointing out the bad part of it. I think the good news story is that cutting corners didn't work, that market discipline and regulatory oversight worked, and the market was strong enough to survive it.

The CHAIRMAN. Thank you, Senator Gramm. I think it has to also be added to that, however, something that Chairman Breeden said a while back. The Government is now—the SEC is now seeking to become a member of the creditor committee because the Government is owed money that it may not be able to collect. So it's not entirely a good news story when somebody is going to get hurt. There are going to be a number of people who get hurt before the dust settles and it may well be that the taxpayers will be one party that is injured. Let's hope not.

Senator GRAMM. But, Mr. Chairman, that is money to be paid as a fine, isn't it? It's not money that the Government once had and somehow lost?

Mr. BREEDEN. The Government has already collected $500 million of the $650 million that the court ordered be paid as part of the Government's settlement with Drexel. $300 million represents the full amount of the fines imposed and $200 million represents the first installment for the civil disgorgement fund. The balance of $150 million to be collected is money that was agreed to be paid into the civil disgorgement fund for the benefit of securities fraud victims. No fines are outstanding.

The CHAIRMAN. Senator Shelby.

Senator SHELBY. Thank you.

Mr. Breeden, what has happened to the market makers dealing with the high-yield bonds? I know Drexel was involved in that. Is there a vacuum there now and will other people fill it immediately or will they wait and see what happens in the market?

Mr. BREEDEN. Well, I think the market has an almost limitless ability.

Senator SHELBY. To correct itself?

Mr. BREEDEN. To correct itself for such things. If there is a demand for a security and if there is a market to be made, people will step forward to make that market. I think that has been going on. It's not simply a question of will it happen in the future. We've seen that happening already.

Senator SHELBY. It happens logically?

Mr. BREEDEN. When the final events were announced and the bankruptcy filing of Drexel's parent occurred, there was obviously great concern as to how the market would react. Prices of some securities in the high-yield area rose rather than fell, which indicated that the market certainly had been aware of the situation. The rating changes had been publicly known, and there had been a good deal of discounting well in advance.

Senator SHELBY. Mr. Breeden, I know in not just my State of Alabama but a lot of States, probably the majority in this Nation, most of their companies could not qualify or would not be able to issue investment grade bonds. I know in my home State that the high-yield bonds have helped a lot of job creation and a lot of companies' access to capital and they're paying it and so forth.

Do you think that the market is going to keep working as far as high-yield bonds? There's a demand for capital out there and with what restraints?

Mr. **Breeden**. There's no question, Senator, that there is a demand for capital. I think that creditworthy companies will find that there are still an enormous number of financial intermediaries who will seek to help them meet their capital needs. I would hope that over time Congress and the administration can work together to also increase the ability and incentives for people to be able to use equity capital rather than different versions of debt securities because I think the greatest strength and the greatest capacity to make long-term investments for the future by both small companies and large companies comes from equity capital.

Senator **Shelby**. Would you explain taking in the high-yield bond area a step further the phenomenon of collateralization of these bonds and what is the upside to it? I know it's growing fairly fast. And what is the downside risk?

Mr. **Breeden**. Well, in any security, whether it's in this area or in the mortgage-backed securities, there are a wide variety of asset-backed securities we've seen over the last 10 years as part of the overall process known as securitization—institutions taking and issuing different types of pass-through securities in which car loans or lease financings or credit card receivables, or mortgage payments or other obligations are passed through to the holder of a security. And to a lender, whether it is a bank lender or an investor in a type of security, a collateralized secured promise to pay tends to be treated as more valuable than an unsecured, uncollateralized one because there is less risk. Consequently, the more secure the lender is, the less the lender charges as a premium for the use of his funds. So collateralization has proven to be for many companies an effective way of reducing the interest cost that they might otherwise pay.

Senator **Shelby**. It can also increase in the market for it.

Mr. **Breeden**. Well, for intermediaries it certainly provides liquidity to allow them to replace funds that have been lent out through securitizing that investment.

The disadvantage or the offset that any given company has to weigh in looking at creating a collateralized obligation is that collateral becomes unavailable to the extent it's pledged to a particular security. It's not available for future use in other areas. So there is, in some degree, a loss of flexibility in the future traded off for a present reduction in the interest that might have to be paid.

Senator **Shelby**. But if people are looking for more security, this is a different twist to it, isn't it?

Mr. **Breeden**. Certainly in any type of security, to the degree collateralization is utilized, it reduces credit risk.

Senator **Shelby**. Thank you, Mr. Chairman.

The **Chairman**. Thank you very much, Senator Shelby.

Senator Wirth.

Senator **Wirth**. Thank you very much, Mr. Chairman.

I'd like to go back if I might, Mr. Breeden, to the issue of information again and who has what kind of information.

We've talked about the information between the subsidiary and the parent and the issues you raised in your testimony. Let me try another piece of this about whether you have as much information as you need or we ought to change the law.

In Tuesday's Wall Street Journal, there was a life insurance company who ran an ad for concerned annuity policy holders suggesting that they roll over their annuities to this particular life insurance company.

We did a good deal of research on this and found out that this life insurance company has a lot more junk bonds than it does capital in surplus. Then we called up the company and asked them about what was going on in this and one of the things that they urged in their letter to us was to be sure to check the bond rating and the amount of funds held in the high risk stock of real estate and then they say check our prospectus, and the prospectus that they sent is something that looks like this [indicating]. That's the prospectus that's given out to people. It's hardly the kind of information——

The CHAIRMAN. Did they give you a magnifying glass with which to read that?

Senator WIRTH. That was about it. In any case, the question that this raises clearly goes again to the issue of the information that's available.

Another part of this, let me just read another part that was troubling about this. In the material that they sent they said, "This 5-year plan gives you all the security of a bank certificate of deposit plus the enormous advantage of tax-preferred growth."

Now it doesn't give you all the security of a bank deposit but the implication is that this is FDIC insured. I mean that's the first thing that I would think and we are right back where we were.

These are securities that we are talking about here and yet this is an insurance company making these arguments. What does that suggest to you about your jurisdiction or what we ought to do for your jurisdiction? Again, I come at this from having chaired the committee on the House side and I was deeply concerned about assuring that we had a strong SEC and we maintain the level of regulation and funding over there at a time there was a great pressure to deregulate and so on and I come at it from the perspective of wanting to give you all the resources that you need, but you have to tell us what you need and say, "Hey, we really have to move on this."

That is an open-ended question for you. What do you need?

Mr. BREEDEN. Well, Senator, it's my own personal opinion that no type of security—other than a U.S. Government security—should be exempt from the disclosure requirements provided in the 1933 act even if they happen to be issued by a bank, which is currently exempt, or a savings and loan which is currently exempt, or an insurance company which in many cases is exempt. I think what investors ought to have is full disclosure on a comparable basis of what's behind the types of products that they are offered out there in the marketplace. So I would personally be very supportive of Congress repealing the numerous exemptions that have been created from the registration requirements under the securities act because where they are applicable I think they work pretty well.

Senator WIRTH. Could you give us a list of those exemptions that you think ought to be repealed?

Mr. BREEDEN. I would be happy to give you a complete list. Certainly sections 3(a)(2) and 3(a)(5) of the 1933 act.

Senator WIRTH. Could you list the ones that you think ought to be repealed or changes ought to be made?

Mr. BREEDEN. Certainly.

Senator WIRTH. In addition to providing the information, what jurisdiction should you have? For example, on the issuance of bank securities, something that we've been talking to you about, what jurisdiction should you have over this particular operation, the insurance companies and these kinds of claims related to what are essentially securities?

Mr. BREEDEN. Well, I don't think that a bank should be able to issue securities without registering them with the SEC—not with a bank regulator, but with the SEC.

Senator WIRTH. They now register them with the bank regulator, right?

Mr. BREEDEN. Yes. If it's a security of a bank as opposed to a bank holding company. A bank holding company has to register its securities with us. But today, where the issuer of common stock or any other type of security, no matter how sophisticated, is a bank, that offering is subject to the rules of the banking agencies, not the Commission.

Senator WIRTH. Can you also give us a list of those offerings that you think the SEC ought to have jurisdiction over which you now have no jurisdiction over?

Mr. BREEDEN. The types of securities offered?

Senator WIRTH. Yes.

Mr. BREEDEN. Yes, I'd be happy to.

Senator WIRTH. Is this spillover? Should you have any authority in this particular area when this kind of claim gets made?

Mr. BREEDEN. As a general matter, I think any security that's offered to the public ought to be subject to the registration requirements of the Securities Act. It's designed to provide consistent and comparable disclosure.

Senator WIRTH. As a general principle, that was one of the principles of the Brady Commission as well, wasn't it?

Mr. BREEDEN. As well as the Bush task group even before that.

Senator WIRTH. And it has not happened. The administration has now backed off from that I understand as a general proposition. I know you're an independent agency and don't speak for the administration.

Mr. BREEDEN. I'm not aware of any backing off in that area.

Senator WIRTH. Well, I asked Secretary Brady about it when he was here before, about some of the rationalization of jurisdiction issues and there was not the forthcoming response that was pretty clear I thought in the Bush report and in the Brady report.

Mr. BREEDEN. Well, in the area of the insurance products that you're suggesting, obviously one of the problems is that the entire regulation of the insurance industry is currently conducted at the State level. Just as banks offer deposit products that are not generally construed to be securities—insurance companies also offer certain products that are regulated by the insurance regulator, not the securities regulator. We don't seek to take over the regulation of every financial product, but I do think that we ought to have one securities regulator and one securities law applicable everywhere in the country——

Senator **Wirth**. If that were true, every insurance business in Chicago who are dealing in securities——

Mr. **Breeden** [continuing]. On the same philosophy that you have to comply with the 1933 act and go to the Commission whether you happen to be a computer manufacturer or an airline or a shoe manufacturer. Every type of company in America is subject to the securities law, with some exceptions. And I don't see a rationale in most cases for the exceptions.

Senator **Wirth**. Mr. Chairman, thank you very much.

The **Chairman**. Thank you, Senator Wirth.

Senator Dodd.

Senator **Dodd**. Just picking up on Senator Wirth's last point, Richard, Senator Heinz, my cochair of the Securities Subcommittee, and I sent a letter on January 4 to Secretary Brady and to you asking for legislative recommendations. The due date was yesterday. We've had no response to that. We would like to get some legislative suggestions. I think we have a good idea how you feel about it personally. In fact, I have a very good idea how Secretary Brady feels about it. He's talked to me on a number of occasions privately about it. But my view is, until we get some legislative recommendations I don't think the subcommittee—I can't speak for the full committee—is likely to want to move into this area. So I would urge that the response be forthcoming as soon as possible because I know of your deep interest and concern. We've got to move at some point, or at least engage the debate on the questions of jurisdiction and margins and other recommendation made by the Commission. So we will be anxious to hear from you.

Mr. **Breeden**. I have been trying to make a few casual suggestions along the way as to those particular things.

Senator **Dodd**. You keep on throwing the ball up here with casual suggestions. We want some of those fine recommendations, such as that package of legislation from the SEC.

Mr. **Breeden**. Well, in our own defense I can tell you that we have a rather thick set of proposals in response to your letter and that of Senator Heinz, and we are also rather overdue in response to the chairman on some issues, and both of them are sitting waiting to get sent up here in the very near future. Really most of the work is completed now, and we do want to get you not casual suggestions, but formal recommendations.

In the area of the jurisdictional conflicts, frankly, we've also been trying to work with the other agencies which have an interest. We are not the only agency with a perspective on this. We participate in the President's Working Group with the CFTC and the Federal Reserve and the Treasury, and we have been trying to develop a consensus viewpoint, to the degree we can, before we go off on our own with recommendations that reflect our own separate views. So there is some of that work going on.

Senator Dodd. I would prefer to have you wait a few days if you can work something out with the other agencies. But, again, I raised the point only because Senator Wirth has raised it, and I know the chairman is interested in your suggestions and obviously I am as well.

One of our witnesses we will have next week at our hearings on the securities industry has described the present condition of the securities industry as in a period of recession, and I'm using his word on this. He says the industry has lost 40,000 jobs in this business since 1987, profits are at an historic low, junk bonds are at a very low level, bridge loans are in trouble and you've got a slump, even though there are some firms that are operating well. But if you start looking at all of the things that have occurred, it's hard not to agree that in fact the industry is in a kind of a recession.

In light of that, simultaneously, as you know, we are facing some of the toughest competition that we will ever face, or have faced, globally as the European Community moves toward 1992, and the competition and the attraction to go offshore, and I wonder if you might just take a couple of minutes and describe for us what you generally, think are the weaknesses and strengths of this industry.

Mr. Breeden. Well, certainly some of the problems you allude to are very real, and since 1987 in particular our average volume in purely brokerage activities has been down substantially, which results in a reduction of revenue for some firms that is quite significant.

Also, the number of initial public offerings and other offerings of particularly equity securities has been significantly reduced, and during the course of 1989 the volume of high-yield securities that were being issued also experienced a substantial reduction.

So whether it's in brokerage or whether it's in traditional underwriting activities, there have been reductions in revenues which are in some cases quite significant at the firms, and they have responded by trying to cut costs, including in the personnel area.

At the same time, as you suggest, I think there are a number of strengths of the industry. The United States has only 1 of the 25 largest banks in the world, but we continue to have, I think it's 11 of the 22 or 23 largest securities firms in the world. We have 5 of the top 10. Our four largest securities firms have capitalization that is virtually equal, and it's about a billion dollars less than the four largest securities firms in Japan. So the securities industry in the United States is intensely competitive on a global basis. I think we have the finest innovation and creativity in our firms. We produce new products, and we have consistently shown our strength in competitiveness.

So that, while there are certainly some problems currently given the level of activity in some of these markets, there is great underlying strength.

Senator Dodd. So you're satisfied that we enter this period in a strong position?

Mr. Breeden. Well, I'm not satisfied in the sense that there are a lot of improvements that we can make, and you and I have had a chance to talk about some of them. I am not satisfied with a system in which, to the degree one of our strengths is innovation and creativity, every new product has to be subject to 3 or 4 years of litigation before we can get it out of the courthouse and into the marketplace. Because we are the only major nation in the world that divides the regulation of securities and derivatives on those securities, we are the only nation in which you have to spend 3 of 4 years litigating to find out whether something is 100 percent a security or only 99.9 percent a security, in which case the total system of regulation changes.

So we impose on ourselves costs and overhead, in many cases significant, that we don't need to incur and that no other nation with which we compete incurs. So I'm not satisfied and won't be satisfied as long as some of the things that we can do to improve our own system are left undone, and I certainly hope to work with you and Chairman Riegle and the other members of this committee to try to clear some of these problems away.

Senator DODD. Let me, if I can, Mr. Chairman, ask just one additional question on that point because I know you've got to move on.

Gerald Corrigan of the New York Fed recommended in light of the Drexel situation that more needed to be done, beyond the information gathering provisions of the Market Reform Bill. He suggested minimum capital standards for broker-dealer holding companies. How do you react to that suggestion by Mr. Corrigan?

Mr. BREEDEN. Well, I understand Jerry's perspective on that. As you know, the Bank Holding Company Act, which the Federal Reserve administers does have consolidated capital requirements. There are some benefits from consolidated capital requirements, no question, in controlling the degree of leveraging of the overall organization.

There are costs to that style of regulation as well, and you have to be very careful in evaluating the level of costs on the industry. I'm not eager to do anything that will increase costs, especially where such a step would not increase revenues, create any new lines of business, or provide an offsetting increase on the income side.

So I would like to see us start with getting the information about where the problems are and what they are and see if we can't control them with capital regulations and perhaps with some modifications at the broker-dealer level and with those early warning fire alarm kind of provisions that the Commission suggested.

If we find that's not enough as we go forward, we can always come back and suggest other types of changes, but I don't think we need to leap quite as far as Jerry may have suggested at this stage, and I'm just very concerned about the costs of doing so.

Senator DODD. And, last, I was going to ask you about the $600 million owed to foreign countries and $120 million owed to Portugal in the Drexel case. It's a major concern. Our colleague, Phil Gramm, unfortunately, has left. Except for a few jobs being lost here, it seems to be we are underestimating the implications here. There has been a lot more than just a few jobs lost here when you've got $600 million owed to foreign countries and $120 million owed to Portugal itself. That's a major problem it seems to me, and I would be interested in your response to that kind of a situation and what needs to be done to provide some sort of protection from that kind of a situation.

The CHAIRMAN. Thank you, Senator Dodd.

Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

I would like to pursue two lines of inquiry. The first follows up on the questions that Senator Dodd was just asking.

In today's Washington Post Chairman Greenspan is quoted as having stated his support for the provision in the pending legislation that would require holding companies of brokerage firms to disclose more information about their activities to the Securities Exchange Commission.

If you had had the information that that legislation would have provided available to you on a timely basis, what difference in actions by the Commission and ultimate impact of those actions on Drexel Burnham would you have anticipated?

Mr. **Breeden**. Senator, it's difficult to say all the things we might have done. Certainly we would have been certain of our ability to restrict movements of capital out of the broker-dealer before they got too close to fully depleting that capital.

Because we did find out about the transfers, we were able to put a stop to them when they got to a level at which we were not sure that there was compliance with the capital rules. But a more accurate base of information and appreciation of the overall financing picture of the parent would have helped us be more certain to accomplish that result.

Certainly we might have worked with the company to help analyze the question of whether given the pressures that were on them they should be trying to operate at the size at which they were trying to operate. These firms have a lot of choice. There is no law that made the management of that firm try to run a $28 billion operation given their level of capital and given the problems that they were having. Had we known the depth of some of those problems, even without having any direct regulatory authority over all the parent's operations, we might have encouraged them to consider shrinking the firm down to a smaller and more manageable size and reducing that pressure that came from the vast quantities of unsecured, very short-term liabilities that they had at the parent level.

Obviously, one can fairly ask why would you want to find out about the obligations owed to foreign governments or the degree of short-term financings if you are not seeking the specific authority to approve each of those things or to control them.

We do think, that at a minimum, it would be a benefit to be aware of problems as they are growing and to then focus carefully on the operations of the regulated entities to make sure that we do the advance planning and take all the steps necessary to ensure the result that happened in this case, that we are able to protect the public customers, that we are able to help them unwind the positions in the firm, if that becomes necessary, and that broker-dealers and their customers are not suddenly confronted with a SIPC liquidation or other form of insolvency that might leave billions and billions of dollars of trades interrupted. We think that's very important.

I wouldn't want to say to you that, if the Market Reform Bill had been passed, Drexel might not have failed, but I would definitely say that we would have a stronger system of regulatory oversight if we had better knowledge of all the financial exposures, or at least all the material financial exposures, that these firms choose to incur.

Senator GRAHAM. Just a follow-up question on that issue. In a number of pieces of legislation there has been great reliance placed on firewalls, either firewalls vertically between a parent and a subsidiary or horizontally among various subsidiaries of the same parent.

Do you have any comments as to what this Drexel case says about the effectiveness of our current attempts to insulate one financial activity from another of a conglomerate organization?

Mr. BREEDEN. Well, on the one hand, this case certainly shows that merely having separate corporate affiliates, a holding company structure with different companies, will not confine a company's liquidity problems. When the market becomes aware that there are problems in the parent, that awareness will cause changes in the availability of liquidity to all of the subsidiaries because the market is going to look and think of this as one company. There will be an adverse impact on the broker-dealer of exposure to substantial loss in some unregulated affiliate. I think that risk, which we have been very concerned about for some time, was certainly demonstrated in this case.

At the same time, I think this does show that the holding company format with operating subsidiaries that have specific regulatory systems applied to them can be made to work and work effectively in insulating a regulated subsidiary from problems occurring in the parent holding company.

There were expectations among some people notwithstanding the fact that the parent organization here and its other affiliates were unregulated and chose to conduct their business as part of an unregulated, uninsured entity, that there would be some obligation of the Government to come to their assistance in the event they encountered troubles, and that surely we could not distinguish between the regulated entities and the unregulated ones. I think that this situation does demonstrate you can make those distinctions.

We can and did protect that broker-dealer and its customers, and the Fed moved very strongly to protect the Government securities dealer and the Government securities market.

So I think you have to be realistic that when there is a problem in the entire company, the market will treat it that way. That doesn't mean that there can't be parts of a firm that we will protect to a higher degree than other parts of a firm. If the system is set up that way and the market is on notice of it in advance so there are no surprises, then I think that form of regulation can work quite effectively.

Senator GRAHAM. Mr. Chairman, my time has expired. I had another area that I wanted to ask about.

The CHAIRMAN. Do you have just one more that you want to do? Why don't you do that now. Then I want to see if Chairman Breeden can hit the fast balls over the middle of the plate here; I'm sure he can.

Senator GRAHAM. Well, I think this is going to be a slow curve. Because of the outrage of the absence of spring training, the pitchers are not at their form that they should be.

Returning to the earlier discussion about the——

Mr. **Breeden**. Senator, I left my batting helmet back at the office. So be careful. [Laughter.]

Senator **Graham**. Returning to the earlier questions relative to junk or high-yield bonds, one of the explanations for the expanded use of this particular form of financing during the decade of the 1980's was that the access to some of the traditional capital markets for small or emerging firms, particularly equity financing and financing through commercial banks was either unavailable, less available or not available at terms that were as attractive as those that were now available through these high-yield securities.

In light of what is a significant reduction in the availability now of high-yield bonds, how do you see these more traditional forms of financing entrepreneurial ventures in their ability to pick up that part of the market that the high-yield bonds have been providing during the 1980's?

And as a follow-on question to that, if there are any restraints on these more traditional areas, possibly restraints which contributed to the emergence of the junk bond market, do you have any recommendations to this committee for congressional action, or are you considering any administrative actions through your position that would help mitigate those restraints?

Mr. **Breeden**. Senator, it's certainly an excellent question, and if I could I'll start at the end of the question and work my way backward.

I don't think the high-yield market arose out of regulatory restrictions or other artificial barriers, if you will, to more traditional forms of intermediated credits, specifically bank loans. The fact of the matter is that financing with high-yield securities proved to be cheaper and less costly than financing with equivalent intermediated bank loans. In that regard, that fact is not unique to high-yield securities. Commercial paper has virtually displaced short-term bank financing for major American corporations. Twenty years ago large U.S. corporations might go to the bank to finance their short-term activities. Today they simply issue short-term commercial paper, and the reason they do is that it's cheaper. Similarly, the reliance on long-term investment grade securities as opposed to long-term bank loans has increased.

So as part of the phenomenon that people often refer to as securitization, what we have seen across the credit quality spectrum is the emergence of a securities system that seeks to match up the ultimate investor and the ultimate user of funds, with the intermediary not taking the credit risk and not funding the match with its own balance sheet. Rather, securitization simply facilitates the movement of funds from the ultimate investor, whether it's a pension plan or an individual investor, to the ultimate user. That process is more efficient and cheaper.

It's one of the reasons why we need to go back to reexamine and make some alterations to the Glass-Steagall Act because the traditional market of the banking institutions for intermediated credits just isn't nearly as efficient and can't produce funds for the users of that credit at as low a cost as can securitizing credits.

So I don't think that there will be a disappearance of high-yield securities or of the availability of securities for companies in that part of the credit spectrum that has financing needs. There may be changes in the prices that they have to pay, since the market constantly reevaluates the risk and return ratios that are expected. But I don't think that that type of security is going to dry up it's efficient and there is a need for it and there will be plenty of institutions that will provide it.

Senator **Graham**. Thank you, Mr. Chairman.

The **Chairman**. Thank you, Senator Graham. We may touch on that a little bit more here. I want to go through with several items that I think are very important for us to pinpoint.

First of all, I'm wondering what impact, if any, do you think the Drexel failure should have on this larger question of financial services modernization and the future regulation of financial holding companies?

Mr. **Breeden**. Well, I hope it will be an incentive for us to move more quickly rather than for us to hold back. I think it's very clear that there are a number of areas in which the current system, in my judgment, ought to be modernized. There are international competitive reasons we ought to do that and there are stability reasons we ought to do that. We can make a more competitive and a safer system, and I hope that event will help move us forward in that process.

The **Chairman**. What kind of regulatory framework is that likely to require?

Mr. **Breeden**. Well, I would hope it would include enhancements as we have discussed to the oversight over holding companies of broker-dealer firms, and as the legislative process goes forward we can look at the degree of that type of oversight. At a minimum that we ought to have more information than we now get about those types of activities and their firms.

I would hope that we would reexamine carefully, as Congress has directed to occur, the scope of deposit insurance in our system. We have trillions of dollars of underwritten funds, and the question of how much the taxpayers ought to have to underwrite the exposures of banks and thrifts is something that I know the Congress is interested in. I think we may be able to make some improvements in that area.

I think that the fragmentation of the oversight structure among Federal agencies as well as between Federal and State agencies, which perhaps once was a luxury we could afford, is increasingly doing damage to our competitive posture in the world. We ought to look very carefully at creating a truly national integrated securities market and a national banking market as well.

Obviously there are a number of concerns about the role of the States in regulation and supervision that given the importance of locally owned institutions, we can't disregard. We have some important traditions in this area, but I think we can make some improvements that will increase the liquidity and the efficiency of our market.

The **Chairman**. When you mention fragmentation, what do we need to overcome the fragmentation on the regulatory side?

Mr. **Breeden**. Well, we're reviewing a variety of ways in which we might do that. That is the subject of much of the inquiry and analysis that we're trying to engage in with the President's Working Group.

One of the difficulties in answering that, Senator, is that it's not a stand-alone question. It also relates to what kinds of changes are being made in these other areas. If we are going to change and perhaps completely repeal the Glass-Steagall Act, that has implications for the kind of structure that we ought to have in regulation and, depending on how we treat deposit insurance, implications for the regulatory structure.

So it's not a situation where we I can say well, there are three things that in all cases, irrespective of what happens in those other areas, ought to get done. I would certainly like to eliminate to the degree we can, the fragmentation that now exists, between the securities market and the derivatives of securities. At least if we can't eliminate the oversight fragmentation, then we need to find some way of coming to grips with the very real problems it creates—the litigation that I spoke of earlier, the potential for intermarket fraud with single transactions crossing the line between two different sets of policemen and the potential for instability that can be created if you have dramatically different leverage rules and different markets.

So there are some improvements that we have to look for in between securities and the derivatives of securities.

I would like to see a reduction in the number of different agencies that regulate securities. As I was speaking of earlier with Senator Wirth, we have not one securities regulatory agency at the Federal level, but five. In addition to the SEC, the Comptroller of the Currency and the Federal Reserve and the FDIC and the OTS all regulate offerings of securities under the 1933 act and all regulate ongoing 1934 act disclosures. I think we could centralize the regulation of securities offerings and securities disclosure under one agency.

So there are a number of areas where we could make needed improvements. As you know, it can produce a 400-page book, and I don't want to give you an hour-long filibuster here about it.

The CHAIRMAN. Let me go to one other specific point. I think you've made some useful suggestions in your response, including that if one envisions doing away with the Glass-Steagall Act or Bank Holding Company Act, does the Drexel experience and the movement of money back and forth between the holding company and the broker-dealer tell us something about the importance of tough firewalls. I'm talking about firewalls that we understand and that will work with severe penalties if anybody tries to circumvent their protections?

Mr. BREEDEN. I think the Drexel situation shows us the importance of asking in advance what the level of Government involvement is and what the nature of our interest is with any particular type of operating company, whether it be a subsidiary bank or a subsidiary broker-dealer. Is it deposit insurance? Is it protection of brokerage customers? Or is it protection of the system to make sure we have in our minds the goals we are trying to achieve and then set clear rules as to how we are going to achieve those goals—whether it's capital requirements or firewalls against self-dealing and other types of activities that we may conclude are potentially damaging and harmful? Then we should have very realistic systems for oversight and for deterrence to make sure that when we decide a rule is necessary that it gets enforced and obeyed.

We have a great many of those protections, and I think we can move to reducing some of the arbitrary barriers. I think we could substantially modify Glass-Steagall. I think we could substantially modify, if not eliminate, the exclusivity clause in the Commodity Exchange Act. There are a number of these arbitrary competitive barriers that we could remove and have a regulatory system of holding companies with operating subsidiaries that would be effective.

But, as you say, I think firewalls are very important in that process, are an essential part of the process. We have to take a look at what kinds of things we want to prohibit. We may not need to prohibit all cross-sales of products, for example, but certainly the kinds of self-dealing and fraud questions and the kinds of financial accounting questions that are raised by some of the intragroup transactions that may occur are critical and we need to regulate those activities.

The CHAIRMAN. Well, let me take that point over into a different area. Your proposal obviously depends on having very competent regulators. I mean you have to have people that know what they're doing and have the resources they need to be vigilant. So you've got to have a good structure to be on top of things.

As the Chairman of the SEC, you enjoy the confidence of this committee, as I and others have expressed today. But when I look at the Drexel situation, the Drexel board of directors consisted of numerous very sophisticated individuals, including two former chairmen of the Securities and Exchange Commission.

I must say I'm having a hard time understanding the responsibilities of an outside director of a broker-dealer and the extent to which those obligations, however defined, were really carried out in this case. It really is somewhat striking, that we could have such a body of expert people in the central command center of that company, the board of directors, and yet somehow not fathom what was going on, stop it or correct it.

So is the SEC looking into the activities of the Drexel board of directors?

Mr. BREEDEN. Senator, we are trying to look in a very comprehensive way at everything that occurred in the course of this situation. I would not want to single out any particular individuals in answer to your question because we intend to do a very thorough review of all the activities and the participation of the different individuals in those activities. That is particularly so where the decisions may have impacted on the likelihood that, for example, the final payments would be made to the disgorgement fund under the settlement. It is actually a part of the settlement agreement, that the firm do nothing that would imperil the completion of its obligations under the agreement and the court decree that enforces that. We also will take a look at steps that might have been taken that prejudiced the broker-dealer and may not have been in compliance with our regulations.

So I think you can be assured that as we go forward we will do a thorough review of all the actions that occurred that were significant, and that we will be able to determine and report to this committee what appropriate action ought to be taken.

The CHAIRMAN. Do we have a clear understanding as to what the responsibilities of an outside director would be in a broker-dealer? Are those obligations clearly set forth so we have something to measure against?

Mr. BREEDEN. Well, there would be two types of obligations. One would be the obligations that would arise under State law for any type of corporation incorporated in the same State. There are fiduciary duties that directors of any corporation, including a broker-dealer, have to the shareholders and to others.

In addition, there are special obligations that officers and directors of broker-dealers have by virtue of the securities laws and by virtue of the regulations of the applicable self-regulatory organizations—the New York Stock Exchange in particular and the NASD, whatever in a particular case the appropriate SRO would be.

So I would hope that directors in each case would be fully aware of their responsibilities that emanate either from their general status as a director under State law or specifically from the securities laws, and I don't think there should have been any lack of awareness of the duties to which they were subject.

The CHAIRMAN. Is the SEC likely to bring any enforcement action against anyone at Drexel based on a failure to supervise matter?

Mr. BREEDEN. Senator, I can tell you that we will consider all appropriate actions. As you know, I could not and it wouldn't be appropriate for me to make predictions of actions that we might take before the Commission has in fact voted to take those actions.

The CHAIRMAN. Well, let me ask you to do this for the record. I appreciate the sensitivity, the difficulty and the importance of making that assessment. I think the committee needs to have for its records and its purposes what the SEC sees as the requirements of a top executive of a securities firm to supervise properly. In other words, I would like to know what there is in the way of either an established code of conduct against which someone's actions might be measured or what that is thought to be if it is not in writing. I would like to know what is in place as the standard. If you could give us that as apart from how anybody in this case measures against it, that would be useful for us to have.

Mr. BREEDEN. I would be happy to do that, sir.

The CHAIRMAN. Let me move now to commodity transactions. According to a number of different sources, immediately preceding the bankruptcy filing Drexel's commodity trading subsidiary apparently engaged in a series of transactions. What kinds of commodity transactions took place, and were these in any way unusual?

Mr. BREEDEN. I can't tell you all the types of commodity transactions that the affiliates of the broker-dealer may have engaged in outside the broker-dealer or as a proprietary matter, for the account of Drexel, the firm.

The two types of commodity transactions in general that were going on were customer transactions and proprietary transactions.

The customer transactions by and large were going on in the broker-dealer, and there were commodities accounts for customers at the broker-dealer. I'm not aware of any problems arising out of that type of trading that were unusual.

There was a substantial amount of commodities activity conducted in the affiliates. There were transactions in a number of metals, including gold and platinum. There were transactions in oil and I believe gasoline. There were transactions in a whole variety of commodities. I'm not sure that there were any commodities they didn't transact business in, but I can't give you a full list of everything that they traded in, it was very substantial in size amounting to billions, not millions, of dollars of trading. They were very active in currencies, they were very active in all the bullion markets.

This is a major trading firm and they conducted, like other major trading firms, activities all over the world in the major markets in major commodities.

The CHAIRMAN. Was there a burst of commodities activity as we were getting close to these very severe difficulties. Does that show any kind of a pattern through speculative trading of that sort to try to save the company? Is there any sign of that?

Mr. BREEDEN. I don't know. This unregulated activity gets back to the question of the scope of our authority. This is going on outside the broker-dealer and we get no reports about it and we have no legal authority to go in and examine it.

The CHAIRMAN. I know you're collecting facts, but do we know enough about the volume of commodities trading activity? You say it was in the billions. Did it seem to be above the normal levels and was there a burst that occurred just prior to the demise of this company?

Mr. BREEDEN. I would be happy to take a look at that question to the degree we have authority. I'm not aware that there was a special burst of activity. I'm more aware of just the levels when we became aware of the depth of the problem and got current reports as to where they were at that particular moment in time. I don't have a good picture over time how that may have ebbed and flowed.

The CHAIRMAN. Let me ask you a different question. As private capital sources were drying up for the affiliate and money was being taken out of the broker-dealer and upstreamed into the parent, was that money being used for commodity trading?

Mr. BREEDEN. I think some of it may have been used either in trading or to repay obligations that were coming due. There was, as I mentioned, more than a billion dollars of short-term funding at the parent level, and that consisted of commercial paper and then a number of commodity markets financing transactions. As their access to the commercial paper market shrunk, their reliance on the commodity markets as a source of funding grew, and they did conduct a number of transactions in which they were engaging in short sales of different types of commodities and using for a temporary period of time the proceeds of those transactions with a repayment obligation.

There may have been a use of some of the excess capital that was moved out of the broker-dealer to pay down some of those obligations or to satisfy some of those obligations as they came due.

Now when I became personally aware of the capital movements out of the broker-dealer and looked at the volume, and at that time there was more than twice the total remaining capital of the broker-dealer in these types of short-term obligations, I decided that we should not permit any further transfers because of the difficulty in accurately valuing the broker-dealers portfolio securites for purposes of determining whether it had sifficient capital. So we put a stop to this.

There was a substantial volume of these financing transactions, billions occurring every day. I don't want to be unresponsive, and yet I can't tell you. We don't yet know all the facts and we are continuing to look very carefully at it.

The CHAIRMAN. Well, it sounds to me like what may have happened in this case is that the parent was draining capital out of the insured broker-dealer to relieve its liquidity crisis as private sources of borrowing were drying up. The parent may have taken a lot of gambles in the commodities futures or options markets where if the market went the right way they could recoup; at least they bought themselves some time to let the gamble play out. Of course, if the gamble goes the wrong way, then you not only could lose the money in a desperate way to try to save the company, but also end up exhausting the resources out of the broker-dealer.

Is there any indication that that may have been what was going on here?

Mr. BREEDEN. Well, Senator, I want to be very careful because I don't want to create the perception that some of these transactions in some of these commodities were unusual although they may sound quite esoteric, and I think to the ordinary person they are. As I said, this was one of the largest securities and commodities firms in the world. It was actively trading, and in many areas that trading may have been very professionally and competently conducted.

For example, in many of these commodity transactions they were quite frequently hedged rather than being purely speculative positions.

The CHAIRMAN. So you had both kinds. You had the hedge positions, but then you had the stand-alone positions.

Mr. BREEDEN. There may have been some stand-alone, more speculative positions. This gets difficult for us to know because the offsetting hedge transaction may be in affiliates.

The CHAIRMAN. We don't monitor that, do we?

Mr. BREEDEN. No, we don't. There is no one that monitors the entire organization and everything it's doing.

The CHAIRMAN. Would the CFTC have been monitoring that do you suppose?

Mr. BREEDEN. Well, the commodities exchanges in which they were taking positions, some of them domestic and some of them foreign, would all have been monitoring on a daily basis the position of the firm in their exchange and its level of margin and its level of exposure. The CFTC would get reports and was undoubtedly monitoring their positions in the domestic exchanges, although not all of their positions by any stretch of the imagination were in domestic exchanges.

The CHAIRMAN. So there was really nobody watching the whole pattern of activity in the affiliate where this was going on I take it; is that right?

Mr. Breeden. There was no single regulatory authority that had oversight or jurisdiction over all their activities in all the different markets in which they would have been participating.

The Chairman. And if I'm right, $300 million was moved upstream out of the broker-dealer while this problem was coming to light and something happened to it. Maybe it's still there or maybe it's lost. We don't know, I take it, even yet fully what happened.

Mr. Breeden. Well, actually the number was larger than $300 million. It was probably in the $400 million range that was ultimately moved out of the broker-dealer.

The Chairman. In a short space of time?

Mr. Breeden. Well, over the period of a month.

The Chairman. That's a pretty short space of time.

Mr. Breeden. So if that's what we mean by short, and given that we're looking at a 50-percent contraction in the capital base in the space of a month, it may have in fact happened on 1 day or over 3 or 4 different days spread over a month. I don't know the precise sequence of that, but it was over a fairly compressed period of time. I don't know what all those funds were used to do.

The Chairman. Will you be able to reconstruct that now? Do you have sufficient authority as things stand today to be able to piece that puzzle together, or can you be blocked from even after the fact assembling all the information?

Mr. Breeden. I don't know whether we will encounter any blockages down the line. We are trying rather vigorously to take a look at the transactions that occurred and the movements of money within the firm. I don't know that we will have the ability or authority to necessarily reconstruct, and I'm not sure I would want to try to reconstruct all of their daily trading activity everywhere in the world.

The Chairman. Well, I'm not talking about each and every last one.

Mr. Breeden. I also want to be careful here. They may not have been required to have been kept in the broker-dealer, and therefore it may have been perfectly legitimate to use what was not required to be in the broker-dealer elsewhere in the company.

So I would not want to discourage firms from overcapitalizing their broker-dealers by suggesting that once they put money in a broker-dealer, that they could never take it back out again even if it was well in excess of their requirements. So it is not necessarily true that there was any wrongdoing or misapplication of those proceeds.

The speed with which these events were occurring and the trend, when you see the bottom fall out of the bucket and the water all disappearing at that rate of speed caused us to reexamine their capital position. We will try and find out, to the degree we can, what usage was being made of those proceeds.

The Chairman. Well, that's an important point, and I hope you will pursue that. We want to help you pursue it, but I have to come back to the fact that the SEC is now asking to go on the Creditors Committee because you've got what, $125 or $150 million——

Mr. Breeden. $150 million.

The Chairman [continuing]. $150 million outstanding which you may or may not collect. The reason you want to get on the Creditors Committee is you're concerned about getting the money that is due the Government.

So even though there was an intervention, we can't say today whether the intervention was timely enough because we still don't know who is going to take the losses. I mean Senator Dodd talked about some foreign governments and Portugal being creditors. I mean that's why you're seeking a spot on the Creditors Committee; isn't that right?

Mr. BREEDEN. There is no question that there will be losses for creditors as a result of this failure, creditors of the parent corporation and creditors of its affiliates, unregulated and uninsured affiliates, and if the Government of Portugal or any other lender chooses to extend credit to an unregulated, unsupervised and uninsured trading company that happens to be owned by the parent of a broker-dealer, there is no guarantee there. They are dependent on underwriting the quality of that extension of credit and making sure that the people they lend the money to have the capacity to pay it back. But there will be creditor losses. We are a creditor also and we are concerned about that.

So I would hope that those losses can be minimized. We have avoided losses to the customers of the broker-dealer, which is not in bankruptcy even today. It has never filed for insolvency, it has maintained its compliance with the capital rules, it is in compliance today with its capital rules and we've been able to wind down its portfolio in an orderly manner.

So I think if I can separate this into two areas for you, we have been successful in preventing the customers of the regulated entity from suffering a loss. We did not have the obligation to protect creditors of the holding company, and there will be losses at that level.

Two other really quick points. One, we are a creditor at the parent level. I would like to just make it clear. We are not a creditor in our own capacity, but we are a creditor as a representative of the beneficiaries of that fund and, second, we have not been admitted to status as a voting member of that Creditors Committee.

We think that there is a pretty good argument under the law that we ought to be admitted to that Creditors Committee, but if we are unsuccessful in that effort, we may need to come back to Congress and suggest an examination of that area to make sure that in this type of situation, which I hope is never repeated, that our ability to protect the beneficiaries of such a fund is absolutely clear and unequivocal.

The CHAIRMAN. I'm going to ask you one other question now and then give you some questions for the record. You've been very patient and we've got another very important witness that we need to hear today.

Let me ask you about the bonuses. It's reported that Drexel paid $350 million in bonuses to its employees in the 2 months preceding the bankruptcy filing, which is very close to the amount of money that Drexel apparently needed to continue its operations.

I'm wondering is it possible or is it likely that Drexel management believed that the company's collapse was imminent and the bonuses were just one final way of getting funds out of the company? Let me ask you that first, and then I have a follow-up to that.

Mr. BREEDEN. Mr. Chairman, I think that is one of a number of possibilities, and we don't know whether that was in fact the motivation for any of those payments.

I can tell you that immediately upon learning of the size of the bonus payments we commenced an inquiry, which is going on as we speak, about the payments that were made and the facts and circumstances under which they were made. We are going to continue that investigation until we have all the facts.

The CHAIRMAN. Is there any power that you have to rescind those payments if you find that they were inappropriate?

Mr. BREEDEN. Well, certainly some of them, depending on the facts, could potentially be preferential payments for purposes of the bankruptcy proceeding and could be——

The CHAIRMAN. Disgorged.

Mr. BREEDEN [continuing]. Could be repaid as any preference in contemplation of bankruptcy under the Bankruptcy Code can be recovered. So the Bankruptcy Code is certainly one area, and as a creditor there again we would have, like other creditors, a right to have preferences set aside. We may have other authority in this area, and the nature of that authority may depend on the facts and circumstances, and I would like to not speculate unduly on the kinds of things we might do to respond, depending on the facts as we find them.

The CHAIRMAN. Does the SEC have the power, if it should decide to do so, to take an enforcement action against a Drexel executive who ordered that bonuses be paid if you find that they were improper?

Mr. BREEDEN. There are a lot of conditional elements in the question there. We have pretty broad authority to take enforcement activity against any behavior by an officer or director of a broker-dealer that is improper under the standards of the securities laws or the requirements of the exchanges which, as you know, are quite extensive. So that if there was improper conduct under the governing rules and standards of conduct, I would say we would have very broad authority to respond to it.

The CHAIRMAN. I'm going to finish by saying the letter that I referenced at the beginning that was sent in October on the nature of the junk bond market, is now even more relevant in terms of how this market works and how quotes are established and who makes the market with Drexel out of the picture. Those are very important questions.

I know you are in the process of finalizing a response to that. We need to get that, and I know you're working on it, but I want to ask again that that work be finished so that we can put that in place with the other information that we're gathering now.

Mr. BREEDEN. Mr. Chairman, I recognize, No. 1, that it's important information that the committee needs and, No. 2, that you've been extremely indulgent with us in our trying to assemble in a comprehensive way that information. I would expect that you will have that information, that report next week, and I'm doing everything I can to try and get it to you in a timely way, and we appreciate your cooperation in working with us on that.

The CHAIRMAN. I'm going to give you some other questions for the record. There are a number of questions from colleagues, too, that they feel strongly about, and I know you will respond to those, too, as quickly as you can because we want to complete the committee record and get it into print.

Let me thank you for your testimony and excuse you as a witness. I want to call Mr. Kohlberg.

Mr. **Breeden**. Thank you very much.

The **Chairman**. Thank you.

Let me invite those that are leaving the room to try to do so as quickly and as quietly as they can. We want to move ahead with our next witness.

We'll wait just another moment for people to be seated.

Let me say that on occasion we have the good fortune to have expert witnesses before the committee that I think bring very special insight and professional knowledge of a kind that we need to have and often are not able to have. I think that applies to the witness we now have who has come at my personal invitation. I greatly appreciate his willingness to accept my invitation.

Jerome Kohlberg, Jr., is someone that I know to be a very private and a modest man, and one who has always been extremely reluctant to make personal statements or appearances. Given this evident lack of need or interest for publicity, I'm especially grateful that he has accepted our invitation today, and I am very pleased that he has been willing to provide his expertise as we reflect not just on this case, but the broader ramifications and implications of the discussion that we have underway here.

Mr. Kohlberg is the general partner of Kohlberg & Co., which is a private merchant banking firm specializing in management buyouts which he founded in May 1987. Previously Mr. Kohlberg was a founding general partner of Kohlberg, Kravis, Robertson Co. from 1976 to 1987. Mr. Kohlberg was a senior partner and member of the executive committee at Bear, Sterns & Co. before founding what is known as KKR.

He holds an LLB from Columbia Law School and an MBA from the Harvard Business School and also has a BA from Swathmore College. He is a member of the board of managers of Swathmore and a trustee of Columbia University and the American Museum of Natural History. So I am very pleased that you're here today.

These are very important subjects not just for this committee and the Senate and the Congress to understand, but for the American people to be able to understand and make sense of. And I think you're able to help that process along.

So let me at this time invite you to make whatever opening comments you think are appropriate. When you are finished, I will have some questions I would like to raise with you.

We are delighted to have you today.

STATEMENT OF JEROME KOHLBERG, JR., GENERAL PARTNER, KOHLBERG & CO., NEW YORK, NY

Mr. **Kohlberg**. Thank you, Senator.

I am here to be of help if I possibly can.

Let me first say that I am very supportive of the committee's efforts to shed light on the trouble in the financial community as exemplified really by the Drexel matter, and I think that's more visible now than it was some months ago.

Also, I would like to just say that, as you know, or I hope you know, that I come to this forum, and you certainly do, Senator, with a background in a fairly narrow segment of the financial community, namely known as leveraged buyouts, although I started out in the industry a little more broadly.

I've defined this as the purchase of a company for the long-term pull with a prudent management, with a prudent amount of leverage and where the management has an opportunity to become owners as well.

These transactions have, some to the contrary, have done well. I think they have proved themselves beneficial and profitable over time. The original merchant bankers, and I may want to define that at some point, such as myself, make money when the investors make their money, or should make their money when the investors make their money.

Such transactions, I believe, are able to work for the long term, carry a strong involvement for the investors and a commitment by management. To me they are not the more recent phenomenon of a breakup of a company often referred to as a leverage liquidation.

Now I think it's abundantly clear that there have been excesses and, as a matter of fact, I would like to put this in a little broader perspective. I think we could well look back on the 1980's as a decade of excess.

I feel that what we are endeavoring to get at today is a part of that longer and bigger picture. The 1980's carried a general atmosphere, in my view at least, of laissez faire, deregulation, increasing budget deficits, a declining educational system, a declining work ethic, and the declining role of the family.

It was in the earlier years of this decade and in this atmosphere that Drexel singled out and concentrated on the high-yield market which came to be known as the junk market. Even here one has to differentiate among the many imaginative and different types of securities in these high-yield securities in the junk bond market, particularly those with cash returns and those without cash returns. There is a world of difference.

There was a very legitimate crystallization that Drexel accomplished, but after time excesses crept in everywhere in other firms and not merely at this one firm. Buyers who bought these high-yield securities should not have bought them, particularly in the excesses that they did and outside the rule of prudence.

Also, huge fees came into play for placing these securities, which fees began to naturally cloud, distort or even corrupt judgment. It could be said that these fees by definition showed that the bonds were too risky.

Conflicts of interest also set in and gradually permeated all too many transactions once again clouding judgment. Firms oftentimes on both sides representing both buyer and seller were receiving fees for this as well as raising money and receiving additional compensation on occasion oftentimes in the form of warrants.

These fees were contingent upon the consummation of the transaction, which also includes the fairness opinions investment bankers have provided, and naturally it, too, influenced even the best of judgments.

So, too, in the corporate world there were excesses. A void had been created ever since about the 1950's with the decline of the substantial and controlling shareholders, such as the duPonts, Mellons, Rockefellers, et cetera, the names we all know and knew. They used to watch over the companies, and at the same time while they were protecting their own interests, they were protecting the interests of the small shareholder.

Into this void I think stepped the CEO, and basically, and we can go into that, had no one to whom he was truly accountable. Again, there followed excesses of compensation, perquisites and resulting inefficiencies and even lack of ability to compete, in my opinion, particularly in these days vis-a-vis Japan, Germany, et cetera.

The same thing, as you people here know, was happening in our world of government, which was also displaying excesses of corruption, increasing deficits, bloated military budgets, out-of-control health care and hordes of homeless.

What are the remedies? I think the machinery is already in place. I don't think we need more government. I think the banking agencies already have the power to discipline the excesses that exist there both in the S&L's and in the commercial banks.

The SEC particularly has the powers we've seen in the last couple of hours, the power of bringing sunshine to these excesses, exorbitant fees and conflicts of interest by bankers, investment bankers, merchant bankers, management and also lawyers.

I truly believe that the light of day will call forth the pressures of the marketplace which will impose its own discipline. More government is not the answer, but better utilization of the agencies and the people that are in place.

Now there might be a few suggestions that I would put forth, such as the banning of green mail and the two-tier tender offer, which I think are being considered and are on the way to I hope being accomplished.

But also I think, particularly at the SEC, there needs to be more thought regarding rules for the conflict of interest as well as definitions of independence for directors and others.

I think the more recent phenomenon where some of the pension funds, particularly the State pension funds of California and New York are making an effort to step into this void that I think exists in our corporate structure, and I think that should be encouraged by the SEC. I think more light again should be shed on anybody that deals with the public, and these pension funds today own really more than 50 percent of our companies and should be given information.

Their words should be listened to, and their interests should be regarded, and the best way to do that is to put the light of day on this. I think the proxy machinery that presently exists stems from the older days and is slanted too much toward the management and toward the corporation itself.

That really concludes my statement, Mr. Chairman. There were a couple of things that I noted while testimony of the Commissioner was going on, and I might just mention that.

The **Chairman**. Please do.

Mr. **Kohlberg**. I think it's somewhat clear that the SEC could use a little strengthening, particularly in the muscle of having the muscle to require numbers, and it may well be that you will want to consider that anybody that deals with the public, whether it's through a subsidiary or not, should be subject to that same scrutiny. I know that applies in the banking world, that if you own a bank anything else you do is subject to their scrutiny as well.

Senator Shelby I recall being concerned with the capital needs of this country. I think he is right. I don't think the high-yield market is going away. I think it will be there. Nonetheless, I think particularly this committee has to give some thought to the fact that our capital is more expensive than our competitors, particularly Japan.

Why that is so, we can argue all day, but I would for one suggest that we do something about the savings rate so as to increase the savings and have our own people at least finance our deficit. I would love to see that deficit go way down, but at least we shouldn't become further the biggest debtor nation, and therefore I think savings are a big aspect of this.

That's all I have to say, and I would be pleased to answer any questions and help in any way I can.

The **Chairman**. Thank you very much.

We were noting the other day the degree to which the United States now relies on foreign money to handle our increasing debt. Just a few years ago, about 15 percent of the total outstanding Federal debt was held by foreign lenders, and therefore we were dependent upon their willingness to loan us that amount.

The total amount of outstanding Federal debt has gone way up since then, but the percentage now held by foreigners has gone up to 20 percent. So we now have that much higher degree of reliance on being able to attract this foreign money.

I am of the view that this upward pressure that we're seeing on interest rates right now is probably going to continue. While no one can make a meaningful forecast on future interest rates, I think when you look at the capital needs around the world—especially with the Berlin Wall down and the enormous capital requirements in Eastern Europe—the need for money will increase. The investments have to go in.

So the world's savings pool now has some new people knocking at the door, and that means that the United States with its enormous appetite for foreign borrowing is going to find itself having to be in the line with more people seeking capital. But I think the full dimensions of that are not yet fully understood for a country that has gotten itself way out on this debtor's limb. So I just mention that in passing off the point that you mentioned.

You mentioned the high fees associated with excessive junk bonds, and I'm wondering what costs, if any, do they bear beyond the deals themselves?

Mr. **Kohlberg**. I think there is an indirect cost in that they really make for higher prices of companies obviously by definition, but also by reason of the compulsion that comes from those who are pushing the deal.

If you're going to receive as a banker or a merchant banker, if you're going to receive $20 million if the transaction takes place and nothing if it doesn't, I think there is a push there that makes for a higher price than would otherwise be the case.

In my short introduction I referred to the difference in high-yield securities, particularly those that pay cash and those that don't know as picks or zeros, et cetera.

I think what has happened over the past several years is the prices of companies have been escalated by use of these noncurrent pay securities, because when you couldn't justify and finance the current pay of the cash paying debt and everything else and justify your investment, the gap was filled by what I call these tomorrow's securities.

The CHAIRMAN. Future promises to pay.

Mr. KOHLBERG. Right, and let the future take care of itself and in the meantime you see that the fees were up front, and I think it has to color all, even for the best of us, it has to color judgment. So that is what's happening. The excesses were filled in by these particular type of junk bond, not junk bonds in general, but a particular type all too often. I think that's a great deal of the excess that we're talking about.

The CHAIRMAN. It's very interesting to watch how that philosophy has become more broadly attractive. One of the novel aspects of the savings and loan reform package is that it's largely being financed with zero coupon bonds. So that transaction and the systematic use of the Social Security Trust Funds for the normal operations of government are examples of doing things now and pushing the real payment off into the future in some way. Loading up debt or a future repayment requirement has become a very broad practice. You see it now in public finance all over the place.

Mr. KOHLBERG. It's called off balance sheet financing.

The CHAIRMAN. Off balance sheet financing is now the order of the day. The zero coupon bond concept, as it applies in that area, is analogous to what you talk about in terms of these financing arrangements where a transaction really can't stand the test of producing money now. So it is financed and put off into the future where income may or may not materialize. Now, it's looking as if the future has gotten here quite quickly in some of these deals.

Mr. KOHLBERG. Yes.

The CHAIRMAN. And they haven't materialized and they are being redone.

Mr. KOHLBERG. The original intent oftentimes is to sell off pieces of the company at higher prices so as to pay off these debt securities. The problem is that that doesn't always work out as anticipated.

The CHAIRMAN. And that's quite contrary to the philosophy that you outlined in your statement. You talked about the fact that some years ago when we thought in terms of leveraged buyouts, the idea was to manage a company over the long pull in some different way. It wasn't, I take it, as frequently viewed as a situation where you come in and you cut the company into pieces and you sell off pieces as part of a elaborate set of financial transfer activities where there are fees being generated and lot of front-end money being collected by somebody, ending up with a corporate corpus down the line that may not bear much resemblance to what it was that was taken over.

It seems to me that is a radical departure from the earlier philosophy that you speak about where a group of people, often including the management, would look at a situation and feel that they could come in, recapitalize it, take over that business, manage it over the long term more efficiently. In effect you've effected the transfer of management and ownership to a large degree, but you've kept the company intake.

Mr. **Kohlberg**. That's correct, and I would add that part of that ingredient is the extra motivation and incentive that comes from ownership. Both the investors and the management properly done, that motivation of ownership is a wonderful thing and it does fill this void that I referred to before and that I think has been created since the 1950's when there is really no ownership by the professional management in most of our companies today, the public companies.

The **Chairman**. And I think very little accountability. I think you make the point again, I mean who moves in is the oversight force that really provides the constructive good on an ongoing business. I think there has been a gap there. Your reference to pension funds now showing more interest in having a say as the owners, as you point out, by proxy of behalf of the pensioners.

Mr. **Kohlberg**. Michigan is one of the bigger ones.

The **Chairman**. Yes, it is. But one of the things that concerns me there is that at least there is a force coming into the vacuum. It seems to me that I see a lot of the short-term thinking being applied by pension managers. In other words, it looks to me as if a lot of the time pension decisions are driven by short-term considerations, trading performance numbers over a 90-day time period or over a 6-month time period. It looks as if there is an awful lot of transactional activity going on and a lot of churning going on, that's just a personal view, that seems to be separate and apart from this question of taking the long view. There are a lot of things that drive this, including the tax laws.

But I'm not sure that the institutional pension manager is going to be able to come in and fulfill that role. If he can't I'm still wondering where the discipline comes from. Where can it come from, or are we still going to be left with a situation where we are still out of balance?

Mr. **Kohlberg**. Well, I think, No. 1, the larger pension funds, and you're talking now about pension funds that have $50 or $60 billion today and increasing, have such large positions in companies that they can't really sell, and that's one of the reasons that they are very anxious to have more information and a little more say. So they have to be long-term investors.

But I think also for where they are shorter term, one does have to play the real world of market and show performance. I think we could encourage longer-term thinking by investors by encouraging research development of our companies. A lot of your captains of industry complain that they can't manage for the long term, that they are penalized if they spend too much money or whatever on research development and building for the future when it may not be the best thing for the short term.

So I think we can encourage that kind of thing by copying some of the things that have been done around the world like Japan where they have permitted certain industries to pool research. I think the Government can do a lot to communicate at least there because there because a lot is being done, in other words, to encourage this long-term need for efficiency, and at the same time I think that is why this phenomenon of buyouts does have a legitimate place, and that is because of the ownership.

The ownership is by definition long term, and I've heard a lot of CEO's tell me that they are very, very comfortable like this, much better than being a public company because they don't have a security analyst coming to them every quarter and saying how come they're not getting the stock up. So I think you have to do all these things and think through all these remedies, not one, but they all should be thought of, thought out, talked out and coordinated.

The CHAIRMAN. When you make a reference to the deficiency of American public company corporate management say over the last two decades, and I know you making a generalization and you don't mean that to apply to everybody, but taking it as a generalization if you look at the quality of corporate leadership, how would you grade it on a scale of 1 to 10, with 10 being the top score, as you stake it up against other countries? Are we up in the high end of that range or are we in the five area? Where would you say we have been generally on average in terms of our private company corporate management performance over the last two decades?

Mr. KOHLBERG. I'm not really that familiar with the managements of the foreign companies, but I think our managers are pretty darn good. I think the systems needs improving. I think it should be geared to performance, long-term performance. I think these fundamentals that we need to be competitive should be incentivized preferably without the Government but, if need by, by the Government. But I do think our managements are very capable, but I think they need to be geared more to performance. I think maybe the gap between the top executive and the other echelons needs to be narrowed, but I think good performance should be rewarded and it shouldn't be heads I win and tails you lose, which all too often prevails I think in our corporate structure today.

The CHAIRMAN. Let me switch over to a different area. You mentioned a concern about conflicts of interest, and I thought you put it very well in your statement. How would you suggest that investment banks operate so as to avoid the roles that lead to conflicts of interest?

Mr. KOHLBERG. I have had this argument with Wall Street. I don't think that a firm that is geared to fees and commissions should be doing merchant banking or should be investing as well in a particular transaction. If they want to do one, then they should do that. I'm not saying they shouldn't do both in the same company, although I have some reservation about that because they take different mindsets, and the same way in the banks. I think it's a different mindset to be a trustee for depositors in lending money than what the banks are also currently doing.

But I think if an investment banking firm is going to make an investment in a transaction and represent their own and other people's money, then they shouldn't also be taking fees for that part of the transaction which is basically in conflict so that they are on both sides of these things, like raising money and investing money in the transaction and getting fees for the raising of the money, and I think the same thing for lawyers.

The CHAIRMAN. You don't think that should take place. Is there a lot of that taking place, in your view?

Mr. KOHLBERG. Yes. I think there is sufficient to be concerned about, and I think there have been even other abuses where firms are representing both buyer and seller directly or indirectly, or where they have an equity interest that hasn't been brought to light. I think all those things do constitute conflicts. The same way with directors, it's very difficult to be a truly independent director today, and I think we have to give that thought. I think good well is there, but we're all naturally human, and I think that needs a good deal of scrutiny, talk and thoughtful dialog.

The CHAIRMAN. When you look at the amount of debt buildup in the country these days, both public and private, do you think we are overleveraged? Are we to the point where it really creates apprehension in your mind about the levels of debt that are out there?

Mr. KOHLBERG. I'm not really familiar enough with the overall numbers. I think we're going to go through another continued readjustment just as Drexel is. I think the people that have taken the risk and have been buying securities, whether it's equity or high-yield securities, have to bite the bullet and take losses when they come.

The problem comes in that some of the buyers have been dealing with public moneys for which they are trustees really, and where those kinds of securities should not have been bought. I think there will be a further shakeout, but I don't think overall that we're overleveraged.

I think our companies are properly organized and can compete with Japan which is a highly leveraged society itself, and the same way with Germany. I think we can compete in our present situation. I think the excesses have to be flushed out.

The CHAIRMAN. It seems to me that apart from managerial quality and other factors that might drive competitive performance, if you've got two sets of players that are highly leveraged—ourselves on the one side and the Germans and the Japanese on the other—and they have a very low cost of capital and we've got a very high cost of capital, we start out with an enormous built-in disadvantage. There is a major structural problem imposed on you that you had better figure out a way to make up for them in better products, more efficiency, higher productivity—things that are very hard to accomplish even if you have a lot cost of capital.

Mr. KOHLBERG. That's right. That's why a lot of capital is today being supplied by Japan.

The CHAIRMAN. Well, a lot of the future earnings that will come from those investments will accrue to them and not to us.

Mr. KOHLBERG. Exactly, and that's why we need to get our savings so we can have some of that come back here.

The CHAIRMAN. Let me ask you what are the lessons that you draw from the Drexel fall here, including what you heard this morning as you've sat through the discussion for the most part.

Mr. **Kohlberg**. Well, obviously the agencies that have the oversight have to be more assiduous because I think most of what has taken place had been talked about, and I think those agencies tended to sit back in a bit of euphoria.

I think the SEC, as I indicated earlier, has to bring the light of day to these things particularly. With the exception of a couple of things that we've been talking about, I don't think there is any legislation that is needed, except as you touched on today, but I do think again the area of fees and conflicts need to be brought out in any situation where the public is involved because I think these things are now known and really need to be focused on, and I think it's that light of day that is the biggest thing that is needed.

The **Chairman**. Well, that's very important. We've been fighting to get more light of day on these activities and we're going to continue.

Does it surprise you to find that two of the outside directors of Drexel were former SEC chairmen and therefore presumably people highly knowledgeable about how you run a company and you keep it from collapsing and how you stay within the rules? Does that strike you as something of an anomaly?

Mr. **Kohlberg**. Sure. I think the whole problem of the revolving door between Government and industry is a problem. The Wall Street Journal has treated that recently. I think it's not only a problem with the SEC, which reaches out, but I think you have to be careful of those obvious conflicts again. I think it's sad, but again the balance between letting people make a living when they leave Government and unfairly taking advantage of that position is a very difficult one. Again, I think if we had focused on some of these things we might have avoided Mr. Shad going, for instance, to Drexel. I remember talking about this at the time, and I was in a minority at the time. I think those are very real problems, and hopefully again with the light of day on these things will help. But, sure, it is, to put it mildly, an anomaly.

The **Chairman**. Let me ask you one other thing. You know, we talk about junk bond or high-yield securities and how many there are and what their effect is, and we've certainly seen part of that play out in the Drexel case.

How about the bridge lending? Do you have any sense for the overhang of that activity and what problems there may be that attach to it? Do you have any feel for it that you can help us with?

Mr. **Kohlberg**. Again, I'm not involved in that. I don't see it. I know there are firms, whether it's First Boston or Merrill Lynch and even Goldman have I think bridge loans still outstanding that may or may not be well secured. I know the New York Stock Exchange is concerned about it because they are outside the broker-dealer usually. They are up in the holding company or in another subsidiary. Whether those pieces of paper are translated into other high-yield pieces of paper, I think the fundamental worth of those has to be very carefully scrutinized because obviously they are used by the firms as collateral for loans from the banks.

The **Chairman**. Exactly.

Mr. **Kohlberg**. So you have to worry about the banks that are lending to people that lend these bridge loans. I think there is a concern out there.

The **Chairman**. And when you say banks you're talking about banks that insured deposits.

Mr. **Kohlberg**. Sure.

The **Chairman**. And where the taxpayer is in effect on the hook for the ultimate outcome of those transactions should we experience any sort of major failure.

Mr. **Kohlberg**. Oh, sure. I mean if you take the analogy with the high yield of the junk bonds, some of them have gone down to 10 to 20 cents on the dollar. Now if the bridge loans have any kind of diminution like that, it's cause for scrutiny.

The **Chairman**. Should we undertake by one means or another to get the information and be able to monitor that as a matter of just good public policy? It's a somewhat new phenomenon. In other words, the leveraged buyout movement has grown to such a size and character that these bridge loans are an element of the puzzle that may not have been present in the same way years past.

Is this something that because it might pose a systemic risk or even a risk to a major firm where the public could get hurt by that we should really start tracking the level of that activity?

Mr. **Kohlberg**. Certainly. Do you mean by this committee?

The **Chairman**. Well, somebody, I mean whether it's the SEC having the power to reach in and do it. In the interests of making sure markets will work, not blown apart by mistake or by excess, the public's interest is served, especially in terms of providing deposit insurance through an insured institution that can be damaged by unforeseen failures cropping up. We've apparently managed to avoid that in the Drexel case, but it sounds to me like there was a bit of luck involved in that as well as good work. I mean the next time we might not be that lucky.

Mr. **Kohlberg**. Well, they still have some bridge loans, sure, and I think the answer has to be yes. I know the New York Stock Exchange is endeavoring to look into this because it affects their membership, and I'm sure it does on the NASD as well. Anything that impacts the public, which is supposed to be protected by the overseers, should be looked into. I mean if I do a transaction completely privately, but take a bridge loan of $500 million that all of the sudden when markets change is worth $200 million, that $300 million difference comes out of the firm that made the bridge loan, and that in turn could impact their broker-dealer and the public. So I think it is a very legitimate concern.

The **Chairman**. Now I'm just wondering with the junk bond market having fallen as much as it has and with Drexel now out of the game, there is a real question about the liquidity in terms of trading for some of these junk bonds. I'm wondering if we shouldn't now try to figure out promptly out many bridge loans are outstanding and who has them because it's a very important capital sufficiency issue. If it turns out that bridge loans are de facto junk bonds there are questions about their being counted as a part of an equity base that is providing an important part of the presumed capital to run the system.

If we've had an erosion that may add up to a fairly large overall problem, it seems to me that's something we had better know, isn't it?

Mr. **Kohlberg**. I don't think it's at all premature.

The CHAIRMAN. Well, we might ask for your thoughts, and we're going to have to do some work to figure out how we collect that information. I have a concern about just the question of who holds the junk bonds. This is a separate matter, but we've looked at the list and about 30 percent of outstanding junk bonds, and this is a related point, are held by insurance companies and about 30 percent by pension funds.

But you've got some situations, going back to this point we were making earlier about zero coupon bonds and gimmicks that involve take now and pay later type arrangements, where some pension funds have been emptied out and exchanged for promised annuities based on junk bond payments that may or may not come due at some future date.

So that not only have excess buildup amounts been taken out of the pension funds that would have protected the long-term viability of the pensions, the funds have been replaced on the base level by high-yield securities that may or may not pay off in the future. We still don't know the extent to which that has been done, but it's coming on our radar screen as a matter of concern. The same issue arises with certain insurance companies that made obligations to pay in the future based on that kind of an arrangement which may not hold together.

We don't monitor the insurance industry per se here in Washington. It's done at the level of the 50 States. So it's somewhat out of our line of vision. But when you see large holdings of junk bonds being accumulated in entities like that where there are future promises to pay that are contingent upon those instruments holding their value, I start to get concerned about that. I start to get concerned about somebody who is relying on a promise that their pension or insurance policy will be paid will find out later that there is no money there.

So the ripples and implications that go off in different directions are now taking on some of these dimensions and we're trying to track this down. It's not easy to do.

Are there any other comments you would like to make before we conclude here today?

Mr. KOHLBERG. No. Just that if I can be of help at any time, I would be happy to help.

The CHAIRMAN. Well, I appreciate your coming today.

The committee stands in recess.

[The committee recessed at 12:55 p.m., subject to the call of the Chair.]

[Response to written questions and additional material supplied for the record follows:]

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May 3, 1990

Mr. Edward Malan
Editor
Senate Committee on Banking, Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Malan:

We represent Merrill Lynch & Co., Inc. which is extremely interested in the health and stability of the high-yield bond market. Over the past few months, Congress has had occasion to consider the impact that high-yield bonds have had on corporate America and the economy in general. In this regard, we have enclosed a thoughtful editorial from the New York Times which describes the positive role high-yield bonds have played in our economy and cautions policymakers to carefully examine the long-range economic effects of overreacting to certain events which have been associated with high-yield bonds.

As noted in the enclosed editorial, in the past decade high-yield bonds have promoted economic growth, provided otherwise unavailable capital to many small and emerging growth companies, and helped improve corporate efficiency. Moreover, as also pointed out in the article, because only 5 percent of American companies are investment grade, for the vast majority of U.S. businesses, the high-yield bond market represents one of their only viable means to raise needed capital.

Also, we have heard concerns on both the Hill and in the Administration regarding the availability of information on the high-yield market. In this regard, we have enclosed a paper prepared by Merrill Lynch which discusses this issue.

We appreciate your consideration of the various points raised in the enclosures. If we can ever be of assistance in providing additional information or answering any questions you may have with respect to high-yield bonds or the high-yield market, please do not hesitate to give us a call.

Sincerely,

Barry B. Direnfeld

Brian W. Fitzgerald

Enclosures

The New York Times

Founded in 1851

ADOLPH S. OCHS, *Publisher 1896-1935*
ARTHUR HAYS SULZBERGER, *Publisher 1935-1961*
ORVIL E. DRYFOOS, *Publisher 1961-1963*

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WILLIAM L. POLLAK, *VP, Circulation*

The Perils of Bashing Junk Bonds

Michael Milken is a convicted felon. But he is also a financial genius who transformed high-risk bonds — junk bonds — into a lifeline of credit for hundreds of emerging companies. Snubbed by the banks, these businesses would otherwise have shriveled.

In other words, the Milken case presents issues far more important than one person's slide from the financial pinnacle. There is no condoning Mr. Milken's criminality. But if overzealous Government regulators overreact by indiscriminately dismantling his junk bond legacy, they will wind up crushing the most dynamic parts of the economy.

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Junk bonds are securities that pay high interest because they are issued by companies with little collateral, as is true of new businesses. After the credit crunch of the 1970's, banks retreated from lending to such concerns. So Mr. Milken came to their rescue, raising billions for upstarts like MCI, Turner Broadcasting and the Hovnanian home-building enterprise. About half the money was for capital investment and other internal needs. Used in this way, junk bonds promote economic growth.

The controversy surrounds the use of junk bonds to buy other businesses. And even these acquisitions were mostly non-hostile and non-controversial. Only one in twenty involved a takeover of a large company, and in these, the pressure of large debt impelled new management to improve operations. The mere threat of takeover forced greater efficiency even in non-target companies.

Mr. Milken reminds his audiences that only 5 percent of American corporations have high credit ratings. Cutting off junk bonds means cutting off vital credit for the remaining 95 percent, including nearly every company run by a minority member or a woman. Mr. Milken feathered the financial nest of many fat cats through dubious, even illegal practices. Still, his image as some sort of financial Robin Hood isn't entirely off the mark.

Some junk bond takeovers did harm, ringing up so much debt that even well-run companies like Bloomingdale's were driven into bankruptcy. The takeover binge saddled businesses with debt that creates a cloud of potential bankruptcies. Junk bond takeovers also paved the way for low blows. Raiders threatened managers of target companies with greenmail, a huge payoff at shareholder expense. Over all, however, the final verdict on junk bond takeovers isn't in. Meanwhile, the important need is to stop reacting hysterically to the fraud and excess of the Milken revolution.

First, Congress overreacted to the rash of savings and loan bankruptcies by requiring thrifts to shed all their junk bonds by 1994. This was done even though junk bonds contributed very little to S & L losses, according to Prof. Larry White of New York University and a member of the former Federal Home Loan Bank Board.

Now, state and Federal regulators are pressuring pension funds and mutual funds to divest their junk bonds. The group representing state regulators is considering further limits on junk bond holdings of insurance companies, even though these make up a small percentage of the assets of most companies. And bank regulators are raising their standards, penalizing higher-risk commercial loans.

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The danger of crimping so much capital flow is obvious; a fifth of all new corporate debt issues involve junk bonds. There's a chilling message here for small businesses without valuable assets: Don't look to the banks for capital. Don't look to insurance companies or pension funds. Don't look to Wall Street. In short, don't look. Unless your name is Exxon or I.B.M., prepare to wither.

What's needed is not vindictive junk bond bashing; it's prudent financial regulation. For example, it makes sense to outlaw greenmail. It makes sense to help regulatory authorities by requiring that pension funds, insurance companies and banks provide updated figures for the market value of their junk bonds and other assets.

But a frenzied attack on all junk bonds makes no sense. If that continues, the nation will wind up transforming Michael Milken's downfall into an economic catastrophe.

Merrill Lynch

AVAILABILITY OF INFORMATION ON THE HIGH YIELD MARKET

Martin S. Fridson, CFA

Contrary to popular opinion, the demise of Drexel Burnham did not shut off the flow of information on high yield bonds. To begin with, the following institutionally oriented investment banks all maintain high yield research departments. Their activities include publishing credit reports on issuers and actively disseminating news and opinions by telephone and in seminars. (Several firms also host annual high yield conferences, which afford investors the opportunity to meet with the issuers' senior executives and to obtain updated operating outlooks.)

Bankers Trust
Bear Stearns
Citicorp (startup)
Dillon Read
Donaldson Jenrett
First Boston
Goldman Sachs
Jefferies
Kidder Peabody
Lazard Freres
Merrill Lynch
Morgan Guaranty
Morgan Stanley
Oppenheimer
Paine Webber
Prudential Bache
Salomon Brothers
Shearson Lehman Hutton
Smith Barney
Wasserstein Perella
Wertheim Schroeder

In addition, a number of firms service smaller institutions and wealthy individuals and support their high yield sales activities with dissemination of research:

Barre & Company
Bateman Eichler
Blunt Ellis Loewi
Dain Bosworth
Mabon Nugent
Piper, Jaffray
Stern (M.L.)

High yield research is also produced by a number of organizations that are unaffiliated with brokerage firms. These range from the major rating agencies, which have vastly expanded their noninvestment grade coverage in recent years, to small, boutique operations set up to provide custom research on a fee-per-name basis for institutions that hold less-well-known issues. Not included in the list below are several vendors of specialized on-line services dealing with bond indentures, SEC filings and the like. The common thread in all of these operations is a response to the entrepreneurial opportunity represented by investors' desire for quality research.

Duff & Phelps
Fitch Investors Service
McCarthy, Crisanti & Maffei
Moody's Investors Service
Roy Weinberger Research Associates
Standard & Poor's
13-D Research

Another entrepreneurial opportunity that is drawing a strong response is the need for reliable pricing. Merrill Lynch, for example, has stepped up its coverage in this area to 1,100 issues.

Along with bustling activity in high yield credit analysis, there is a boom in academic research and the study of broader market issues. The Institute of Chartered Financial Analysts sponsored a very successful high yield research conference in 1989 and several for-profit organizations are also conducting seminars in this area. High yield panels have become regular features of periodic conferences held by such organizations as the Financial Management Association, the Eastern Finance Association and the Fixed Income Analysts Society.

Books that seriously address portfolio management issues are also proliferating. Titles include the following:

High Yield Bonds: Identifying Value and Assessing Risk of Speculative-Grade Securities, by Martin S. Fridson (Probus Publishing, Chicago, Illinois, 1989)

High Yield Bonds: Instruments, Analysis and Portfolio Strategies, Edited by Frank J. Fabozzi (Harper & Row, New York, New York, 1990)

High Yield Debt Market, The, Edited by Edward I. Altman (Dow Jones-Irwin, Homewood, Illinois, 1990)

Investing in Junk Bonds, by Edward I. Altman and Scott A. Nammacher (John Wiley & Sons, New York, New York, 1987)

Junk Bonds: Analysis & Portfolio Strategies, by Jane Tripp Howe (Probus Publishing, Chicago, Illinois, 1988)

To summarize, Drexel Burnham was by no means the sole source of information on high yield bonds. Research organizations, publishing houses, authors and finance professors are all competing vigorously to satisfy the demand for research spawned by the $200 billion market in speculative grade securities.

April 9, 1990

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

August 14, 1990

The Honorable Donald W. Riegle, Jr.
Chairman
Committee on Banking, Housing
and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Riegle:

Enclosed are my answers to the questions submitted by you and Senator Sasser following the hearing held before your Committee on March 2, 1990 on the bankruptcy of Drexel Burnham Lambert Group, Inc.

Sincerely,

Richard Breeden

Richard C. Breeden
Chairman

Questions from Senator Donald W. Riegle, Jr.

Q.1. Does the Drexel failure highlight any areas in which regulation is insufficient or needs to be amended? Please respond specifically to concerns raised about the huge funds that were transferred from the regulated broker-dealer to the unregulated parent.

A.1. Generally, the Securities and Exchange Commission ("Commission") believes that its financial responsibility rules performed well in the financial failure of Drexel Burnham Lambert Group, Inc., ("Group") and the subsequent liquidation of Drexel Burnham Lambert, Inc. ("DBL"). To our knowledge, DBL did not violate the Commission's financial responsibility rules during the months preceding its liquidation. Nonetheless, I have directed the Division of Market Regulation to make a prompt and complete review of the Commission's net capital rule as a result of the Drexel failure. In addition, the Commission has approved publication of a request for public comments concerning possible modifications of the net capital rule.

Among the concerns the Commission has identified as a result of the Drexel failure is the sudden and massive undisclosed withdrawal of capital from the registered broker-dealer by the holding company. In this connection, the Commission has proposed amendments to its net capital rule that would require a broker-dealer to give prior written notice to the Commission and the appropriate self regulatory organization ("SRO") of its intention to disburse more than a specified percentage of its capital to its parents, shareholders or related entities. The amendments are intended to alert the Commission to situations such as Drexel, and give more time to take measures in response to the sudden withdrawal of capital from a major firm. A notification rule should give the staff enough time to deny approval for any transfer that might impair a firm's capital, as well as to notify the relevant SRO, which may also determine to limit or prevent the withdrawal of capital.

In addition to an amendment that would require the broker-dealer to notify the Commission when the holding company withdraws capital from the registered broker-dealer, the Commission is also considering amendments to the net capital rule to prohibit withdrawals when the effect of the withdrawal is to reduce the registered broker-dealer's net capital in an amount in excess of certain percentages of the broker-dealer's haircuts on its securities positions. With such a prohibition in place, the broker-dealer would be required to reduce the risk related to its proprietary positions before additional capital could be withdrawn.

The Commission is also seeking public comments on the desirability of increasing the capital requirement of firms that have minimal amounts of customer related receivables, by basing minimum capital on the level of proprietary positions in such cases. Currently, many large broker-dealers elect to use an alternative method of computing net capital. Under that method, the broker-dealer's net capital requirement is based on its customer-related receivables. If the broker-dealer does not have to carry a significant amount of those receivables, its net capital requirement may be low in relationship to the degree of leverage it has attained.

Senator Donald W. Riegle, Jr.
Question 2

Q.2. According to a number of different sources, immediately preceding the bankruptcy filing, Drexel's commodity trading subsidiary engaged in a series of transactions.

Q.2.a. What kind of commodity transactions occurred? Were these in any way unusual?

A.2.a. The parent firm, Group, engaged in commodities transactions primarily through subsidiaries of Group or other Drexel entities that were not registered with the Commission as broker-dealers or in any other form. As such, the Commission had no more regulatory and oversight jurisdiction over these commodities subsidiaries than it has over any other nonregistered entity.

During the course of our oversight of the parent company and the winding down of the businesses of DBL, the entity registered with the Commission as a broker-dealer and with the Commodity Futures Trading Commission ("CFTC") as a futures commission merchant, and of Drexel Burnham Lambert Government Securities, Inc. ("GSI"), the staff of the Commission did make some inquiries into the details of the operations and finances of the unregulated subsidiaries of Group. The information we have comes from discussions with officers and employees of various Drexel entities and from bankruptcy and court filings.

It is our understanding that these Group subsidiaries were engaged in extensive trading in the forward and spot markets for foreign exchange, commodities, and precious metals. They introduced their exchange-traded commodities transactions to the registered broker-dealer/futures commission merchant on an omnibus basis. The nonexchange-traded commodities transactions were conducted by the subsidiaries without being introduced to the registered broker-dealer/futures commission merchant.

From the information we have been able to assemble, it appears that, except as discussed below, these commodities activities were conducted in a relatively accepted manner and did not involve excessive market risk. It is also our understanding that the volume of exchange-traded commodities transactions conducted by these Group subsidiaries, and introduced to the registered broker-dealer/futures commission merchant, did not increase significantly immediately preceding the parent company's filing for bankruptcy.

One business practice of which we are aware that could be questioned was that of the subsidiary Drexel Burnham Lambert Trading Corporation ("Drexel Trading"), of lending to the parent company on an unsecured basis the excess funds generated from selling borrowed commodity spot positions. For example, Drexel Trading would borrow gold from third party entities on an unsecured basis and deliver the gold to parties to whom it had previously sold gold short. Drexel Trading would hedge the short positions by purchasing forward contracts. The net effect of these transactions was to provide another source of unsecured financing for the parent company, in a manner that was not typical of major firms and did involve unusual risk for creditors of Drexel Trading.

Q.2.b. How effectively were these trades monitored and regulated?

A.2.b. The commodities subsidiaries were not registered with the Commission as broker-dealers, and the Commission does not have any information to indicate that they were entities required to register with the Commission in any other form. Under current law, the Commission lacks the authority to collect information concerning the parents or other affiliates of registered broker-dealers in holding company structures. Since these commodities subsidiaries were not registered with the Commission, either as broker-dealers or in any other manner, the Commission did not regulate their trading, funding activities, financial conditions, or overall methods of operation. The Commission also did not have routine access to whatever books and records they were maintaining.

The Drexel occurrence underscores the Commission's need to have the authority to monitor on a consolidated, world-wide basis the activities of broker-dealers' unregulated parents and affiliates in holding company structures. Such authority would enable the Commission to ascertain and to assess adequately the potential exposure of regulated broker-dealers to adverse occurrences or circumstances affecting the broker-dealers' related and unregulated entities. Indeed, the risk assessment provisions contained in the Market Reform Act (S. 648 and H.R. 1609) would have permitted the Commission to monitor the Drexel situation more effectively.

For the future, it is imperative that the Commission have access to information regarding at least the other material financial operations carried out in the unregulated entities within holding company structures. With the ability to obtain such information quickly and on a systematic basis, the Commission would be aware of broker-dealer complexes that are unstable or are highly leveraged. Such information would be particularly valuable during periods of high volatility in the stock market, in interest rates, or in exchange rates. With such information, the Commission would be in a better position to consult with SROs, and domestic and foreign government agencies in order to plan possible responsive actions and to avoid further danger to the financial integrity of the securities industry.

Senator Donald W. Riegle, Jr.
Question 3

Q.3. Certain Drexel executives formed limited partnerships through which they allegedly participated in preferential transactions, receiving hundreds of millions of dollars over just a few years.

Q.3.a. Over a year ago, there were reports that the SEC was investigating the Drexel partnerships. What is the status of these investigations?

A.3.a. Following Drexel's settlement of the civil enforcement action brought by the Commission, the Commission continued its investigations of certain customers and employees of DBL and its High Yield Bond Department ("HYBD"). In connection with these investigations, the Commission continued to collect information concerning certain partnerships established by or for the benefit of employees of the HYBD. To date, the Commission has identified numerous such partnerships and securities transactions by them. The Commission's investigation of these matters is continuing.

Q.3.b. There have been reports that in the months before Drexel's failure, Drexel management agreed to indemnify the individuals who participated in these partnerships against any liability arising from the partnerships. Does the SEC believe such indemnification is proper, and if not, will the SEC try to void these indemnification agreements?

A.3.b. In the fall of 1989, Group and DBL entered into a release and indemnification program with their employees. The release and indemnification for the employees extended to their activities in connection with the Drexel-related limited partnerships. Pursuant to the program, mutual releases were exchanged. Drexel agreed, under certain circumstances, to indemnify those employees who chose to participate in the program for certain claims. The program also contemplated the possibility of releases from Drexel to certain of the Drexel-related limited partnerships. As explained to us, the program was intended, among other things, to assist Drexel in retaining employees and to facilitate Drexel's ability to obtain information from its employees concerning their activities. In this connection, we were advised that Drexel employees were reluctant to provide information concerning their professional activities to Drexel and its counsel because of concerns about personal liability. The release and indemnification provisions were intended to attenuate these concerns. If it did facilitate Drexel's ability to obtain information, the program aided Drexel in meeting its obligation under the Drexel Final Judgment to cooperate and to provide information to the Commission.

The indemnification agreements in the form furnished to the Commission are expressly limited to good faith conduct where the employee had no reason to believe that his or her conduct was unlawful. Also, the indemnification agreements did not provide indemnity to the partnerships as such, but only to Drexel employees who were involved in the partnerships.

Drexel sent drafts of the proposed forms of release and indemnification papers to the Commission for comments. At our suggestion, Drexel made some modifications to the forms.

We have no reason to believe at this time that the release and indemnification program on its face violates the federal securities laws or the terms of the Drexel Final Judgment. Of course, nothing in the releases or indemnification agreement can limit the Commission's ability to bring enforcement proceedings, if appropriate, against anyone.

Senator Donald W. Riegle, Jr.
Question 4

Q.4. Serious allegations have been raised about the use of warrants to conceal the financial interest of persons associated with Drexel. The Committee has been advised that in some circumstances the amount of warrants issued could result in a change of control if the warrants were exercised.

Q.4.a. Under what circumstances do SEC disclosure requirements mandate the identity of holders of warrants? Under what circumstances is that disclosure not required?

A.4.a. The obligation to disclose ownership of warrants may arise in a number of contexts. The beneficial ownership reporting requirements of Section 13(d) of the Exchange Act are a primary source of an obligation to disclose the acquisition of warrants and the concept of beneficial ownership underlies other bases for such disclosure. Where the warrants relate to an equity security registered with the Commission under Section 12 of the Exchange Act, disclosure would be required under Section 13(d) of the Act if the holder of the warrants acquires beneficial ownership of more than five percent of the class of registered equity securities. For the purpose of calculating beneficial ownership, any warrants exercisable within 60 days would be deemed to vest the holder with beneficial ownership of the underlying equity security. Rule 13d-3(d), 17 CFR 240.13d-3(d). Persons who are the beneficial owners of over five percent of the class but acquired their interest prior to the time the class was registered with the Commission under the Exchange Act, would have a filing obligation pursuant to Section 13(g) of the Act. See Rule 13d-1(c).

Securities Act registration statements filed in connection with primary and secondary offerings require disclosure of beneficial ownership in accordance with Item 403 of Regulation S-K. Under this line-item disclosure requirement, a registration statement would contain information about persons beneficially owning more than five percent of a registrant's voting securities, including the beneficial owner's name, the amount and percentage of the class owned, and the nature of the person's beneficial ownership interest. Beneficial ownership is determined by use of the Section 13(d) analysis. Moreover, a registration statement also should include prospective information as to any arrangements known to the registrant that may result in a subsequent change of control. See Item 403(c) of Regulation S-K.

In addition to beneficial ownership disclosure, there is an obligation to disclose information about material arrangements between the registrant and underwriters. Item 508(f) calls for disclosure of any arrangement between the underwriters and the registrant that gives the underwriters the right to designate or nominate a person to the registrant's board of directors as well as the individual's relationship with the underwriters. When such an arrangement is present, the nominee's beneficial ownership of the registrant's voting securities also would be required under Item 403(b) of Regulation S-K. In addition, Item 508(e) of Regulation S-K requires disclosure in the registration statement of all cash and non-cash items, such as warrants, that would be deemed by the NASD to constitute underwriting compensation for purposes of its Rules of Fair Practice.

There is no specific line-item obligation to disclose the names of persons who may acquire securities in a registered offering. Rule 408 of Regulation C, however, would require disclosure of additional information as may be necessary to make the required line-item disclosures of Regulation S-K not misleading, such as the existence of any arrangement or understanding whereby an affiliate of the registrant or underwriter may purchase a material amount of the securities being offered.

Q.4.b. Has the SEC reviewed transactions in which Drexel acted as underwriter to determine if warrants intended to accompany a junk bond offering were detachable from the offering and ended up as payment to persons or entities associated with Drexel?

A.4.b. The Commission staff has reviewed registration statements covering transactions underwritten by Drexel that involved the issuance of detachable warrants. As part of the registration statement review process, the staff issues comments where it has a basis for believing that the disclosures contained in a registration statement may either be materially misleading or omit material information. In regard to beneficial ownership, the staff will compare the registration statement disclosure to the Schedule 13D or 13G beneficial ownership statements filed with the Commission as well as other information available to it. Irrespective of who is named as underwriter, when a registration statement names a partnership or other legal entity as beneficially owning more than five percent of a registrant's voting securities, the staff requests disclosure of the names of the general partners and the extent of their relationship with the underwriter or registrant. Further, and as part of the processing procedure, the NASD is advised of offerings which contain disclosure indicating that the underwriters may receive non-cash compensation, such as warrants, so that they may review and, if appropriate, comment on the issue.

Q.4.c. Are SEC rules and their implementation regarding disclosure of warrants sufficient to protect the public?

A.4.c. The registration provisions of the Securities Act and current regulations and review procedures of the Commission appear adequate to protect the investing public by requiring disclosure of any item, including warrants, that may be deemed underwriter's compensation; material relationships between the registrant and underwriter; arrangements that may result in a change in control, as well as any additional information necessary to make the required disclosure not misleading. Further, the secondary markets are provided information through the beneficial ownership filing requirements of Sections 13(d) and (g) as well as the change in control disclosures required to be filed in a current report on Form 8-K.

Of course, the Commission will continue to review the adequacy of these disclosure requirements based on experience gained in connection with its enforcement actions and the liquidation of Drexel. If the current disclosure requirements prove to be inadequate to ensure that investors receive all material information concerning the placement of warrants necessary to make an informed investment decision, the Commission will propose appropriate revisions to its rules.

Senator Donald W. Riegle, Jr.
Question 5

Q.5. It appears as though neither Drexel management nor Federal regulators were aware of how precarious Drexel's situation was until less than a week before it filed for bankruptcy. Why didn't anyone know?

Q.5.a. Should the Drexel management have known? Is there any evidence that they did know?

A.5.a. There were two basic reasons why regulators were not aware of the specific financial condition of the Group and the other Drexel entities on a consolidated basis until shortly before it filed for bankruptcy. First, regulators are not entitled, under current law, to detailed information concerning holding company parents and affiliates of registered broker-dealers. As a result, while the Commission had a general understanding of the holding company structure, we did not have the type of detailed financial information of the Drexel holding company complex that would have permitted us to be aware of the extent to which the holding company had large amounts of illiquid assets supporting its unsecured borrowings, or the degree of short term maturities in Group's liabilities.

Second, neither the New York Stock Exchange, Inc. ("NYSE") nor the Commission has a rule requiring firms to notify regulators of significant capital movements between a registered broker-dealer and its holding company or affiliates. In light of the Drexel experience, the Commission has approved for publication proposed amendments to its financial responsibility rules that will require such notice.

The Commission and the NYSE, the designated examining authority for the registered broker-dealer, did monitor the financial condition of the registered broker-dealer. That monitoring showed that the broker-dealer was in compliance with the Commission's financial responsibility rules, and that it had reported substantial amounts of "excess" net capital.

The April 1989 settlement, which was entered into between Group, DBL and the Commission, imposed numerous requirements on these Drexel entities designed to ensure and to improve their compliance with federal securities laws. In order to improve compliance with federal securities laws, they were required, among other things, to make certain personnel and structural changes, to allow the Commission or the outside accounting firm selected by the Commission to monitor DBL's High Yield Bond, Capital Market and Finance operations; to limit employee trading and investments; to adopt recommendations for improved compliance procedures made by an independent consultant chosen by the Commission; to create an oversight committee, which would have oversight responsibility for internal controls and internal audit, accounting and compliance functions; and certain other matters. The requirements in the settlement and the Commission's monitoring under the settlement focused upon preventing the kinds of violations of the securities laws that were the subject of the Commission's complaint, such as insider trading and market manipulation. Notwithstanding the extent of these provisions, they did not address directly the Group's or DBL's capital position.

Although the settlement did not deal with capital adequacy issues, the Commission's Division of Market Regulation, in conjunction with the NYSE, had been monitoring the financial condition of the broker-dealer since prior to the March 1989 settlement. This monitoring was designed to help evaluate the impact on the firm of the agreement to pay $650 million to the Government and defrauded investors, as provided for in the settlement.[1]

At the time of the settlement in April 1989 and for the rest of calendar year 1989, DBL had a substantial inventory of high yield bonds. The Commission had concerns over the size of this concentration, and the inherent risk such a concentration created. However, these concerns had to be balanced against DBL's extremely high net capital and net worth. As of the end of May 1989, after payment of most of the settlement, DBL had net capital before haircuts of about $1.5 billion. After haircuts for securities positions, DBL had "excess" net capital of $751.5 million.

Throughout calendar year 1989, the firm's excess net capital never fell below $680 million. Accordingly, after the settlement DBL appeared to remain among the highest capitalized broker-dealers in the United States. However, the accuracy of this reported capital position was dependent on the valuation placed on the firm's high yield securities portfolio, which fell significantly in value and liquidity throughout the second half of 1989. As a result, the Commission staff remained concerned about the level of high yield inventory, and it held a number of discussions with the firm concerning liquidity and pricing issues relating to high yield securities. Despite increased haircuts on the firm's high yield inventory, the firm continued to report high levels of excess capital into January 1990.

As discussed in detail in the Commission's written statement, upon receiving certain information from the Federal Reserve Bank of New York, in early February the Commission held discussions with Drexel to ascertain its financial position. It learned that transfers of capital to Group, coupled with operating losses in January and increases in haircuts on securities positions, reduced DBL's excess net capital from $680 million on December 31, 1989 to $330 million on February 2, 1990. At this time the Commission advised Group and DBL of our serious concerns regarding substantial withdrawals of capital from DBL and GSI, and we instructed DBL not to make further loans or other distributions of capital to its parent or its affiliates without prior consultation with the Commission.

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[1] The firm has paid $500 million of this amount. It still owes $150 million to the fund, and the Commission has been listed as a creditor in the bankruptcies of both the Group and DBL.

The general knowledge of Group's weakened condition in late 1989 had resulted in heightened monitoring of DBL's situation. Occurrences in late 1989 and early 1990 created an environment in which Drexel's financial position began to erode. A decline in the junk bond market had adverse impacts on Group and its broker-dealer subsidiary's profitability and liquidity in connection with junk bond revenues and inventory values. Standard & Poor's Corporation downgrading of Group's commercial paper rating from A-2 to A-3 resulted in Group's paper no longer being eligible to be purchased by money market funds. Group's outstanding commercial paper thereupon shrank from approximately $600 million to $180 million. Based in part on these factors, Market Regulation staff visited DBL's high yield department in December 1989 to discuss liquidity and pricing issues, and it had scheduled a meeting for February 14, 1990 to review DBL's financial condition in detail.

The Commission is not certain at what point Drexel's senior management perceived the likelihood of a liquidity crisis. However, management had substantial early warning that the firm was in an overly leveraged situation. Among other things, a precipitous decline in revenue was occurring at the same time that both the liquidity and the value of the firm's high yield assets were seriously deteriorating.

This underlying deterioration in the firm's viability was exacerbated by several factors. First, although the firm eliminated its retail operations following the settlement of its civil and criminal matters, it continued to concentrate its business in the high yield market and the trading profits and underwriting revenues such operations generated. Moreover, when that segment of the business began to deteriorate in the fall of 1989, the firm continued to conduct business as usual and did not take steps to reduce its leverage and create a more stable balance sheet. Finally, the firm had clear warning of problems in late January, when demands for cash came from unsecured lenders, but the firm took no steps to liquidate positions. Rather, the firm looked solely to the assets of the broker-dealer -- which clearly were not sufficient to meet all of its cash needs.

Senator Donald W. Riegle, Jr.
Question 6

Q.6. What are the implications of Drexel's bankruptcy for junk bond holders, including insurance companies, mutual funds, pension funds, thrifts, foreign investors and individuals?

A.6. Price and market disruptions with respect to high yield securities could require holders of these securities to recognize losses for high yield securities. For example, because of industry specific requirements, thrifts, broker-dealer firms and investment companies must value their high yield holdings at market, rather than amortized cost. Generally Accepted Accounting Principles require that securities held in trading accounts be carried at market value, securities held for sale be carried at the lower of cost or market value, and securities held for investment be carried at amortized cost, unless it is determined that there is a non-temporary impairment of the value of the security.

Particularly with respect to those Drexel issues that were not widely traded and for which other firms had not begun making a market, many feared that the cessation of DBL's pricing services would create difficulties in accurately calculating a market value. The staff, however, has not found any widespread evidence of this problem. With respect to regulated entities, such as broker-dealers, these difficulties could create problems in meeting minimum statutory capital requirements. These risks as well as any impact on liquidity resulting from the Drexel failure would also be expected to be disclosed in the Management's Discussion and Analysis disclosure of public companies.

The Division of Corporation Finance is continuing to monitor MD&A disclosures and accounting practices in this area. So far, the Division has conducted a review of the periodic reports filed by all public insurance companies, publicly held broker-dealers or issuers with a significant broker-dealer subsidiary and created an accounting task force to review the recent public filings of those banking and thrift holding companies considered to involve the highest degree of risk. Disclosure is being examined both for the adequacy of risk disclosure as well as for the extent to which the reporting company's income depends on such activities. This review has resulted in a number of amended filings, elaborating on the risks and effects of participating in the high yield market, and a number of referrals to the Division of Enforcement. In addition, the Division of Investment Management has specifically alerted high yield investment companies to their disclosure obligations and is monitoring disclosures.

Since Drexel's settlement with the Government, investment companies have been gradually moving their high yield bond trading and pricing to other dealers as these dealers broadened their market making activities. When DBL stopped providing its high yield bond pricing service on March 16, 1990 investment companies and other pricing services that had been obtaining prices for some securities from DBL, had already been able to find alternative pricing sources for all but a small number of issues. The industry hopes that in time dealers other than DBL will start making markets in most of these remaining securities and will become a source of daily pricing information. In the meantime, investment companies, as permitted by the Investment Company Act of 1940, can value securities they hold for which market prices are not readily available at fair value as determined by each fund's board of directors.

Because mutual funds cannot have more than 10% of their assets in illiquid securities, such funds do not hold material amounts of privately placed high yield securities. The staff believes that any impact resulting from DBL's withdrawal from the market had a proportionately greater effect on such privately placed securities.

Senator Donald W. Riegle, Jr.
Question 7

Q.7. Will companies that issue junk bonds be more likely to default on their debt or fail to raise capital through other means?

A.7. While issuers may find it difficult to refinance existing debt in order to avoid default, it is too early to predict what the long term effects of recent events will be on issuers with outstanding high yield securities. It is likely that the effect will be issuer specific.

Senator Donald W. Riegle, Jr.
Question 8

Q.8. Drexel collapsed while it was in compliance with federal capital requirements.

Q.8.a. Should broker-dealers have higher capital requirements?

A.8.a. Generally, the Commission believes its financial responsibility rules performed well during the Drexel failure. On February 2, 1990, immediately before the time that Group filed for bankruptcy, its registered broker-dealer subsidiary, DBL, had approximately $330 million of excess net capital. After Group filed for bankruptcy, DBL transferred its customer accounts to other broker-dealers. Once those accounts were transferred, DBL filed for bankruptcy under Chapter 11 of the Federal Bankruptcy Code.

As stated earlier, the Commission has approved for publication proposed amendments to the net capital rule that would require a broker-dealer to notify the Commission prior to withdrawing assets for the benefit of its parent, stockholders and affiliated entities. In addition to a notification requirement, the Commission has also proposed an amendment to the net capital rule that would expand the circumstances under which the registered broker-dealer would be prohibited from distributing its net capital to affiliated parties. In addition to the above proposals, the Commission is also reviewing the adequacy of the net capital requirements for certain investment banking firms engaged in substantial proprietary trading. Finally, other issues, such as the general adequacy of capital levels, will be considered as part of the rulemaking process.

Q.8.b. Should broker-dealer holding companies be subject to capital requirements?

A.8.b. No. The Commission does not believe that it would be appropriate to require broker-dealer holding companies to be subject to a consolidated capital rule. The holding companies of broker-dealers vary considerably in their business activities and composition of assets. Some holding companies do not conduct a business other than the ownership of subsidiaries, and others engage in businesses that are not related to the financial services industry. It would be extremely difficult to construct a capital rule that could take into account the breadth of holding company activities. In addition, holding company capitalization rules are generally not necessary if the capitalization requirements of regulated operating companies are set at an adequate level, carefully monitored, and applied promptly to close, restructure or sell any firm whose capital level falls below minimum requirements.

Rather than consolidated capital rules for holding companies, the Commission believes that the ability to monitor the financial health of the holding company, combined with the imposition of notification requirements regarding intended capital withdrawals from broker-dealers and the NYSE's rules that allow it to prohibit withdrawals, should provide the Commission with effective early warnings of financial problems in holding companies of a broker-dealer and prevent unanticipated inappropriate withdrawals of capital by those holding companies of registered broker-dealers. All necessary corrective action will then be taken with respect to the broker-dealer subsidiary.

Senator Donald W. Riegle, Jr.
Question 9

Q.9. The pending Market Reform Act (S.648) authorizes the SEC to obtain information about the financial activities of affiliates of registered broker-dealers.

Q.9.a. What steps might the SEC have taken had it known Drexel's true condition?

A.9.a. The main interest of the Commission is the financial integrity of the broker-dealer. If the information had shown potential detriment to the broker-dealer, the Commission could have pursued a number of options. A combination of the significant reduction in the liquidity of the junk bond market in late 1989, DBL's decline in underwriting and related revenues, DBL's dependence on this line of business for a major portion of its revenues and Group's continued and disturbing dependence on short term unsecured borrowings (in excess of $1 billion) would have prompted the Commission to ascertain whether Group or any of its affiliates held liquid, pledgeable assets in the event back-up financing was needed, or whether Group had established any back-up lines of credit with banks. Upon learning of a significant reduction in Group's commercial paper program (resulting primarily from a downgrade in Group's commercial paper rating by Standard & Poor's Corp.) and that DBL's uncollateralized inventory was primarily high yield securities that were becoming steadily less appealing to banks, the Commission, in cooperation with DBL's designated examining authority, the NYSE could have suggested that DBL (i) immediately obtain back-up lines of credit or infusions of capital and reduce its exposure, and/or (ii) increase its capital immediately. The Commission and the NYSE also might have requested that DBL not transfer any of its funds to its parent or its affiliates without first notifying the Commission and the NYSE [2], and we would have monitored the firm's capital position on a daily basis. In light of the precarious financial position of the entire Drexel holding company complex, the Commission would have examined DBL's inventory more closely to determine whether particular high yield issues had a ready market or whether DBL should receive no capital credit for those issues. Finally, we might have insisted that Drexel management cancel the large bonus payment program when it was announced at year end 1989.

Q.9.b. As a result of the Drexel experience, does the SEC think the risk assessment provisions are sufficient or are modifications needed?

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[2] NYSE Rules 325 and 326 authorize the NYSE to require a member firm to maintain net capital in an amount the NYSE determines is necessary to meet the firm's financial obligations, and authorize the NYSE to prohibit the firm from advancing funds to its owners.

A.9.b. The Commission believes the risk assessment provisions contained in the Market Reform Act (S.648) would have permitted it to effectively monitor Drexel's situation in late 1989 and early 1990 and no modification tc the legislation is needed at this time. The Drexel occurrence underscores the Commission's need to have the authority to monitor the activities of broker-dealers' unregulated affiliates and holding companies on a consolidated, world-wide basis so that it may adequately determine the potential exposure to regulated broker-dealers of adverse occurrences or circumstances affecting the broker-dealers' related entities. With the ability to obtain this information quickly and on a systematic basis, the Commission would possess knowledge of the firms that are most unstable. Such information would be most valuable during a period of high stock market, interest rate or exchange rate volatility. The Commission would thus be in a better position to consult with SROs and domestic and foreign government agencies in order to plan possible responsive action and avoid further endangering the financial integrity of the securities industry.

Senator Donald W. Riegle, Jr.
Question 10

Q.10. Accounts of the Drexel failure indicate that Drexel executives called the SEC and other government entities seeking assistance.

Q.10.a. What kind of assistance was requested?

Q.10.b. Were any steps taken to assist Drexel? What were they? Why were they either taken or not taken?

A.10. The Commission became aware of withdrawals of capital from DBL, the broker-dealer subsidiary of Group, to meet Group's funding obligations on February 7, 1990. Although Drexel never made any general requests for assistance from the Commission, after February 7, there were frequent discussions with Group by government regulators and SROs. These parties continuously reviewed Group's financial condition, and discussed ways for Group to reduce its financial exposure or increase the capital of DBL.

As the situation worsened on February 9, 1990, discussions between the parties centered on short-term financing needs in the holding company and affiliates and plans by DBL management to meet those funding needs and to achieve a more liquid position. DBL officials informed the Commission that more than $400 million in unsecured debt issued by Group and affiliated entities either would mature or be callable by holders between February 20 and February 28, with an additional $330 million scheduled to mature during the month of March.

Group was placed under substantial financial pressure on Monday, February 12 because of its inability to obtain renewals of unsecured loans coming due on that day. In order to provide Group officials an opportunity to continue ongoing negotiations with their banks, the NYSE and the Commission permitted DBL to lend Group $31 million in the morning to prevent commercial paper payments from being dishonored in clearance. In addition, at the end of the day, the NYSE and the Commission concurred in DBL making a $7 million margin payment to the Chicago Mercantile Exchange for the benefit of Drexel Trading because of DBL's underlying obligation as a clearing firm to make good on such payments.

After direct consultation with the Commission, however, the NYSE refused to allow DBL to lend in excess of an additional $100 million to Group at the end of the day to meet additional unsecured lending of Group or Drexel Trading that had come due.[3] At this point, it had become clear that Group was likely to be unsuccessful in its efforts to obtain either a collateralized bridge loan or a substantial equity investment, and that there was no willingness on the part of investors to continue unsecured lending to Group.

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[3] NYSE Rules 325 and 326 authorize the NYSE to require a member firm to maintain net capital in an amount the NYSE determines is necessary to meet the firm's financial obligations, and authorize the NYSE to prohibit the firm from advancing funds to its owners.

With nearly $400 million in loans to the parent company coming due or subject to being called in the ensuing days, and with less than $300 million in remaining excess net capital in DBL, it was clear that the Commission had a choice of allowing DBL's excess capital to be exhausted in order to avoid a default by the parent company for another 24-48 hours or to protect DBL's capital and allow Group and its unregulated affiliates to default. Without hesitation, we chose to ensure the ability of DBL to effect an orderly wind down, protecting more than 30,000 customer accounts, with $5 billion in customer property.

By maintaining the regulated broker-dealer's solvency, we also were able to protect other broker-dealers and their customers from defaults on trades involving billions of dollars in securities. A sudden collapse of a major broker-dealer such as DBL could have had extremely adverse consequences on confidence in the marketplace and on the smooth functioning of our clearance and settlement system.

On the evening of February 12, 1990, the Commission and the staff of the NYSE maintained continuous contacts with Group, DBL and GSI. In addition, consultations with the other government regulators continued. As a result of those conversations, we advised Group of our concern over Group's solvency and the resultant exposures to DBL and GSI. On the morning of February 13, 1990, Mr. Joseph of Group called to advise that Group was inclined to seek relief under Chapter 11 of the federal bankruptcy code because of the holding company's inability to pay its maturing obligations.

Following the holding company's default and filing for protection under Chapter 11 of the federal bankruptcy laws, the Commission concentrated its efforts in two areas. The first was to facilitate the orderly liquidation of DBL's positions consistent with protecting public investors. The second was to pursue the prompt transfer to other broker-dealers of DBL's approximately 30,000 accounts that contained as much as $5 billion in cash and securities. As an essential part of these efforts, we worked with banks, clearing agencies, securities firms, the Federal Reserve Bank of New York and other government agencies, and other interested parties to facilitate orderly and effective clearance and settlement processes.

**Senator Donald W. Riegle, Jr.
Question 11**

Q.11. What risks, if any, did the Drexel bankruptcy pose to the securities clearance and settlement systems or the interbank payments systems? What systemic risks, if any were posed by Drexel's default?

A.11. The risks from Drexel's insolvency were threefold. First, the demise of the holding company parent posed the risk of a liquidity crisis for DBL because its lenders, creditors, and counterparties, in effect, might insist on settling transactions only on a fully-collateralized basis, might accelerate open contractual commitments, and might refuse to deliver securities or funds in an orderly manner, in effect creating the equivalent of a run on DBL's assets. Second, the demise of the holding company created a risk that settlements in markets where DBL accounted for a significant percentage of trading volume would slow significantly. Counterparties who sold securities to DBL might be unable to obtain their purchase price, funds that may well have already been expended for other purposes. Similarly, counterparties who bought securities from DBL might be unable to obtain their securities, because DBL might not be able to obtain their securities from sellers.

Group's default resulted in losses to its counterparties and lenders. It also increased financing costs to DBL's counterparties in those markets (particularly actively-traded mortgage-backed securities) where settlement gridlock occurred for a temporary period. Thinly-capitalized, highly-leveraged, and badly positioned firms that did not have sufficient resources to withstand those losses or pay the carrying costs could be forced out of business in any such event.

As explained in my testimony before the Committee, these risks were minimized through coordinated action by DBL, its bank lenders, counterparties, the NYSE, clearing agencies and federal regulators. As a result of that action, DBL's counterparties or lenders were able to meet their obligations on a timely basis, DBL's customers did not suffer losses or significant disruption. Most importantly, the failure of the firm and its liquidation were orderly, and did not result in any cost to federal taxpayers, as typically results from a large bank failure.

Senator Donald W. Riegle, Jr.
Question 12

Q.12. There are reports that Drexel relied heavily on "double leverage" to finance its broker-dealer operations. Double leverage means that a firm borrows at the holding company level and then lends those funds to its subsidiary. The subsidiary broker-dealer then uses those funds as collateral with which to raise money. Is such double leveraging a common practice? Does its use increase the risk that an investment firm may collapse?

A.12. The term "double leveraging" refers to the practice of borrowing funds at the holding company level and contributing those funds in the form of an equity investment or subordinated loans to a subsidiary. If the holding company lends the funds to the subsidiary, the advance would be treated as a liability of the subsidiary, and in that case it would not be any different than if the funds were borrowed by the subsidiary from an independent party.

Unsecured borrowing, particularly through the commercial paper market, is common for many large broker-dealer holding companies. Those holding companies frequently invest the funds as equity capital or subordinated liabilities in their subsidiary broker-dealers. In such circumstances it is prudent to make arrangements that would enable a firm to access short term financing in the event the commercial paper holders demand payment. For example, some holding companies maintain liquid assets free of lien available for use in case they become unable to borrow on an unsecured basis. Group, on the other hand, had no such alternatives. Outside of DBL, Group held or had access to only illiquid privately placed investments in the unregulated subsidiaries. The risk of failure increases as the leverage of the firm increases, but more dramatically so if the short term funds are used to finance long term illiquid assets. If the funds are invested in such assets, it is more difficult for the firm to unwind the "double leveraged" borrowing, because the illiquid assets would have to be sold before the borrowing was repaid. The Commission is currently studying whether any legislative or regulatory response is appropriate with respect to "double leveraged" investments in registered broker-dealers.

Senator Donald W. Riegle, Jr.
Question 13

Q.13. Private placements reportedly account for up to 40% of all corporate financing. How does the SEC monitor private placements to determine that the issuer claiming the exemption is entitled to it? How much staff does the SEC devote to this assignment? How many enforcement actions has the SEC brought against private placement issuers for not complying with the limits of the private placement exemption?

A.13. Since the passage of the Securities Act in 1933, issuers have raised capital in transactions that, as permitted by Section 4(2) of that statute, take place without registration (and thus without specific mandated disclosure requirements or review by the Commission). The Congress and the Commission historically have recognized the ability of professional institutional investors to make investment decisions without the protections mandated by the registration requirements of the Securities Act. Indeed, a review of the legislative history associated with passage of the Securities Act demonstrates that the persons Congress intended to benefit from the registration provisions of the Securities Act were unsophisticated, individual investors. In general, private placements with large institutions are made in reliance on Section 4(2) rather than on the safe harbor provisions of Rule 506, discussed below.

Rule 506 of Regulation D provides that transactions made in accordance with its provisions will be considered to be transactions not involving a public offering. Reliance upon the exemption under Regulation D also necessitates the filing of a notification on Form D within 15 days of the first sale of securities.

The antifraud provisions of the securities laws apply to offerings pursuant to Section 4(2) and Rule 506. Additionally, Securities Act Section 12(2) provides a purchaser of a security with an express civil remedy against the seller for misleading statements or omissions negligently made by the seller. Section 12(2) applies not only to public offerings of securities, but to private placements as well. The federal securities laws impose upon a seller of securities a duty of truthfulness, whether or not the transaction is exempt from the Securities Act registration requirements. As indicated above, the statutory private placement exemption is self-operative, and Rule 506 does not require the filing of any materials with the Commission except the notification Form D. However, many Securities Act registration statements filed with the Commission, including those for initial public offerings, contain disclosure concerning unregistered securities transactions occurring during the prior three year period.

In the course of their overall review of Securities Act registration statements, the 184 members of the review staff of the Division of Corporation Finance evaluate submissions relating to unregistered securities transactions and, when appropriate, determine the applicability of claimed exemptions. In addition, the staff analyzes publicly reported information and investor complaints which may alert them to possible violations of the registration provisions of the securities laws.

When the staff is alerted to potential violations of the registration requirements, in appropriate cases, the staff conducts investigations and recommends enforcement proceedings to the Commission. For example, in fiscal year 1989, the Commission instituted 32 injunctive actions alleging violations of the registration provisions of Section 5, six of which involved injunctive actions against issuers who claimed the private placement exemption.

Senator Donald W. Riegle, Jr.
Question 14

Q.14. Insurance companies and pension plans have purchased billions of dollars of junk bonds to fund the retirement plans of thousands of workers. Many of these junk bonds are sold through the "private placement" exemption that allows the issuer to avoid the rigorous disclosure requirements of federal securities law. In light of the risk to the ultimate beneficiaries who depend on these products for their retirement, is the SEC reviewing the adequacy of current regulations and enforcement efforts? Specifically, have you considered requiring issuers to have more than a "reasonable belief" that a purchaser representative has sufficient knowledge and experience to evaluate the risks and merits of a prospective investment? Have you considered revising the definition of "accredited investor" to ensure an understanding of the specific type of security involved in the private placement?

A.14. Since the passage of the Securities Act in 1933, issuers have raised capital in transactions that, as permitted by Section 4(2) of that statute, take place without registration and, thus without specific mandated disclosure requirements or review by the Commission. The Congress and the Commission historically have recognized the ability of professional institutional investors to make investment decisions without the protections mandated by the registration requirements of the Securities Act. Indeed, a review of the legislative history associated with passage of the Securities Act demonstrates that the persons Congress intended to benefit from the registration provisions of the Securities Act were unsophisticated, individual investors. Insurance companies and pension funds have traditionally been viewed as institutional investors. In fact, in 1980 when the Securities Act was amended to add a definition of the term accredited investor, such definition included insurance companies and pension funds, together with such other institutions as banks and investment companies. Most of the states recognize an exemption from their registration requirements for transactions with institutional investors, including insurance companies and pension and profit-sharing trusts.

Rule 506 of Regulation D provides that transactions made in accordance with its provisions will be considered to be transactions not involving a public offering. That rule provides that securities may be sold to an unlimited number of accredited investors, plus 35 additional persons who the issuer reasonably believes either alone or with a purchaser representative have such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of the prospective investment. Although specific disclosure requirements do not apply to offers and sales made to accredited investors, if sales are made to non-accredited investors, Rule 506 requires that such persons be furnished with substantially the same information as would be required in a registration statement.

Because insurance companies and most pension plans are accredited investors under Regulation D, there is no need for such investors to secure a "purchaser representative." Non-accredited investors may require a purchaser representative to be considered sophisticated investors. The "reasonable belief" standard is used with regard to sophisticated investors, because an inflexible, certainty standard makes the provisions unworkable for careful issuers and their counsel. Throughout the regulation this standard is used; it creates an issue of fact which the issuer must demonstrate was resolved in a reasonably prudent manner.

Since investors historically have been deemed not to need the protection afforded by registration and mandated disclosure requirements, the Commission has not considered focusing on the need for accredited investors to understand the specific type of security involved in a private placement.

The federal securities laws impose upon a seller of securities a duty of truthfulness, whether or not the transaction is exempt from the Securities Act registration requirements. Securities Act Section 12(2) provides a purchaser of a security with an express civil remedy against the seller for misleading statements or omissions negligently made by the seller. Section 12(2) applies not only to public offerings of securities, but to private placements as well. The antifraud provisions of the Securities Act and Exchange Act, in addition to Rule 10b-5, also apply in the context of private placements.

If an issuer makes material misrepresentations or omissions in selling securities, such as high yield bonds, the Commission will bring an enforcement action under the antifraud provisions of the federal securities laws. The task of regulating the investment and fiduciary aspects of pension funds, however, has been assigned by Congress to the Department of Labor. With respect to most private employee benefit plans, fiduciary provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"), administered by the Department of Labor, provide that failure by the plan sponsor and other fiduciaries to establish and operate a plan prudently and in the sole interest of employee participants will result in ERISA liability. Investment activities of insurance companies are regulated by the states.

By letter of March 15, 1990, I forwarded to you a staff report on the high yield bond market. In my letter, I noted that the growth of the high yield, non-investment grade market has raised numerous issues that have been, and will continue to be, the focus of attention by the Commission and its staff. As specific problems warranting a change in the law are identified, the Commission will not hesitate to propose regulatory or legislative responses.

Consistent with its responsibility to facilitate full and fair disclosure to investors in entities that purchase a significant amount of high yield securities, the Commission already has undertaken steps to improve the adequacy of information regarding high yield bond holdings and loan activity. For example, in an interpretative release issued last year,[4] addressing the disclosure requirements under the Management's Discussion and Analysis ("MD&A") item of Regulation S-K (Item 303), the Commission reminded filing companies of their disclosure obligations concerning holdings of high yield securities or lending activities in highly leveraged transactions. The release also identified other risks that investors in high yield securities should disclose, such as relevant lending and investing policies, the amount of holdings and the potential risks inherent in such holdings, and other information relating to holdings giving rise to significant risks.

The Release also specifically identified risks that must be evaluated and addressed by investment companies investing in high yield securities. In addition, the Division of Investment Management has specifically alerted high yield investment companies to their disclosure obligations and is monitoring disclosures.

The staff of the Division of Corporation Finance is also monitoring MD&A disclosures in this area for other registrants. These would include publicly-held banks, savings and loan institutions, broker-dealers and insurance companies that have significant assets invested in non-investment grade debt instruments, debt or equity securities of highly leveraged issuers or loans with a high loan-to-value ratio. Disclosure is examined both for the adequacy of risk disclosure as well as for the extent to which the reporting company's income depends on such activities.

The staff will continue to gather data on the high yield bond market in order to promote a full assessment of the need for legislative or regulatory changes, and the likely policy implications of those changes.

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[4] Exchange Act Release No. 34-26831 (May 18, 1989).

Senator Donald W. Riegle, Jr.
Question 15

Q.15. What effect, if any, will Drexel's failure have on the SIPC Fund?

A.15. None. To date, SIPC has found it unnecessary to initiate a customer protection proceeding for DBL or the other broker-dealer subsidiaries of Group.

Senator Donald W. Riegle, Jr.
Question 16

Q.16. With the blurring distinction between equity and debt instruments, should corporate debt transactions be subject to reporting requirements and be as open as the equity markets?

A.16. As I recently stated in my March 15, 1990 letter addressing issues raised by you concerning the high yield market, improved price information concerning transactions in high yield securities would benefit market participants, investors and regulators.

Whether debt instruments should be subject to the same reporting and disclosure requirements as equities, however, presents a more difficult question. For example, a Section 13(d) type disclosure requirement for purchasers of debt securities, would provide information concerning who are the significant holders of an issuer's debt securities. Similarly, Section 13(f) of the Act, requiring disclosure of securities under institutional management, currently does not apply to debt securities. It may, however, be very difficult to get meaningful disclosure concerning the potential control implications arising from accumulation of a company's debt securities. Certainly with respect to a distressed entity, holders of debt instruments have the potential to influence control of the company. However, that result applies to all the issuer's creditors, including bank lenders. For example, a recent study concluded that in one of every four firms that either filed for bankruptcy or privately restructured their debt to avoid bankruptcy during 1979-85, banks either became major stockholders or directly controlled the board of directors. Gilson, Bankruptcy, Boards, Banks and Blockholders (February 1990).

With respect to the issuer's disclosure obligations under the Commission's continuous reporting scheme, current law only requires the filing of reports with respect to a class of debt securities if the debt securities are listed on an exchange (pursuant to Section 12(b)), or the securities were the subject of a public offering (pursuant to Section 15(d)), but in that case only until the commencement of a new fiscal year if the securities are not held by more than 300 persons. The registration requirements under Section 12(g) of the Act, which require the filing of reports with the Commission where the issuer has over 500 shareholders and over $5 million in assets, do not apply to debt securities. Expanding this Section to apply to debt securities would increase publicly available information concerning such issues, but it would also create additional costs.

Senator Donald W. Riegle, Jr.
Question 17

Q.17. To assess potential problems in the junk bond market, the Committee needs to know more about who are the issuers and purchasers in this market. It has also been suggested that better systems for publishing bid and asked prices of junk bond prices should be developed.

Instead of getting more information, the government appears to be getting less. Last year the SEC discontinued collecting data about new securities issues, not just junk bonds. And the planned liberalization of private placements may make information about the bond markets even harder to come by. What is and should the SEC be doing to gather information about these markets?

A.17. As I noted in my March 15 letter and as is reflected in the accompanying staff report, the Commission shares your concern about the lack of information on the high yield market. For example, without fairly extensive data bases, data on the size of the private placement markets necessarily must be based on industry "estimates." In addition, in a letter to Joseph Hardiman, President of the National Association of Securities Dealers ("NASD"), dated May 2, 1990, I requested that the NASD consider whether any existing NASD systems, such as NASDAQ (the NASD's quotation system for NASDAQ securities), PORTAL (a quotation system for privately placed securities eligible for resale under Rule 144A of the Securities Act of 1933) or Bulletin Board (a quotation system for so-called "pink-sheet" securities) could be adapted for high-yield securities.

With respect to the holders of high yield bonds, the Commission, in its 1989 MD&A release, reminded publicly-held institutions, including investment companies, insurance companies, banks and broker-dealer firms, of the need to disclose and to discuss the extent of their holdings in high yield bonds and lending activities in highly leveraged transactions. The release also identified other risks that investors in high yield securities should disclose, such as the relevant lending and investing policies, and the amount of holdings and the risks inherent in those holdings.

From a regulatory perspective, the Commission has been able to obtain information on a confidential basis, either directly or through the exchanges, concerning high yield bonds and bridge loans exposures of broker-deal firms, including that of affiliates. Adoption of the Market Reform Act would serve to improve the Commission's ability to monitor the positions of these firms by mandating this information. Similarly, the Commission is able to obtain information concerning the high yield assets held by investment companies, including high yield mutual funds. Accordingly, while the reliability of pricing data presents significant regulatory concerns, the Commission does have access to detailed information on the holdings of the financial institutions it regulates.

As is the case when estimating the size of any market, data on the overall size of the high yield market, particularly with respect to private placements, will continue to be based on estimates. Although the Commission does not believe that its ability to obtain information on registered offerings has been unduly hindered by reliance on industry data bases, current initiatives to develop quotation and trading systems should enable the Commission to obtain more information regarding private placements and trading in the private placement market.

Senator Donald W. Riegle, Jr.
Question 18

Q.18. Federal Reserve Chairman Greenspan has said that "the time lag between exchanges of financial instruments and the delivery of payment for these instruments in most settlement systems was a problem [in unwinding Drexel's positions] when parties to the transaction were concerned that an event, like bankruptcy, might intervene." There were no such problems in the government securities market, which works on the basis of payment against delivery. He recommended that "thought might be given to the feasibility of extending this type of settlement . . . to other markets." Do you agree?

A.18. The logjams in settling Drexel's liquidating trades were most pronounced in the mortgage-backed securities markets, where some of those coupon instruments still settle through a process that involves the seller delivering securities to the buyer with the expectation that payment will follow later that day. As indicated in my testimony before the Committee, Drexel's counterparties were unwilling to deliver negotiable certificates to Drexel against the promise of payment later that day, primarily because they feared that an intervening event, like bankruptcy, might leave them unsecured. These problems were not as evident in other markets, such as government or corporate securities markets, where central facilities exist to protect against these risks. Also, these problems were not as pronounced in settling those mortgage-backed trades that involved coupons eligible for deposit and delivery at the Participants Trust Company, the central user-owned, federally regulated securities depository for these instruments.

I agree that to the greatest extent possible securities settlements should be conducted through central facilities such as registered clearing agencies that are part of the National Clearance and Settlement System Congress envisioned and authorized the Commission to regulate under Section 17A of the Securities Exchange Act of 1934, or the Federal Reserve System's government securities book-entry system (for those instruments, such as U.S. Treasury and Agency securities, that are eligible for such facilities). These systems are designed and operated to foster user confidence through membership standards, monitoring of member financial condition, collateral or margin deposit requirements, and substantial additional financial resources (through clearing funds, retained earnings, and credit lines) to permit settlements even if a member defaults. Furthermore, because federal bankruptcy laws generally exempt clearing agencies from automatic stay provisions to permit routine settlements and liquidation transactions, counterparty fears of extensive losses due to an intervening bankruptcy filing or petition can be reduced.

Settlement problems were least pronounced in settling U.S.

Treasury securities trades, which are processed through the Federal Reserve Banks and Fedwire, because delivering parties immediately receive "good funds" in their Reserve Bank accounts when they deliver securities. This finality is possible, in part, because Fedwire permits users to maintain overdrafts on an intra-day basis. This has been a matter of concern to the Board of Governors of the Federal Reserve System, which is exploring ways to reduce intraday overdrafts.

QUESTIONS FROM SENATOR JIM SASSER

Q.1. I have to admit to being astonished that Drexel Burnham really believed that it deserved a bailout by the federal government and that it approached federal regulators on this issue. Naturally, I'm gratified that Drexel was turned away.

In banking we have the implied policy of "too big to fail." It appears that one way to succeed in banking is to grow very large so that the government will be afraid of the repercussions should you fail. I think there was a little of this theory at work in the minds of the leaders of Drexel.

Now I don't subscribe to "too big to fail" in banking; I certainly don't in the securities business where there are no federally-insured deposits at risk. Are there _any_ circumstances where the government _would_ rescue a securities firm? What if the securities firm was a large primary dealer in government securities, or if it had a large retail operation?

A.1. The laws of the United States do not grant the Commission the authority to lend funds to a broker-dealer in danger of failure. Moreover, the Commission has never held the view that any particular broker-dealer cannot fail irrespective of the number of customer accounts it may hold or its status as a primary broker-dealer. Rather, it has been the Commission's consistent view that if a firm cannot comply with the net capital rule, the law requires it to bring in capital to achieve compliance or to begin an orderly liquidation. Such measures could either bring the broker-dealer into compliance with the net capital rule, at which time it could resume operations, or cause it to pay off all of its obligations. If the firm had customers, the Commission and relevant SROs would assist the firm in transferring the accounts of customers to other firms.

The Commission and the NYSE, the designated examining authority for most of the larger U.S. broker-dealers, have, in some instances, assisted troubled firms in finding merger partners, selling assets or parts of their businesses or entering into other arrangements necessary to assist the firm in restoring financial viability.

I do not personally subscribe to the desirability of a generalized "too big to fail" doctrine in securities or banking. I also do not believe that agency officials should have the discretion to declare unilaterally that existing creditor rights will be augmented beyond what exists by contract or by provision of law. Where there is not a system of unpredictable public financing of defaults, the marketplace is actually far more effective at evaluating, pricing and limiting financial risk, if given adequate information, than any government agency has ever demonstrated.

Senator Jim Sasser
Question 2

Q.2. Has the fall of Drexel increased the government or the taxpayer's own exposure in the savings and loan bailout, since savings and loans were one of the largest owners of junk bonds, and a good many of these are now insolvent? RTC now holds junk bonds with the book value of $4 billion. Could you estimate what the market value of the RTC's junk bonds is?

A.2. Among other things, the covenants and interest payment features of each high yield bond vary widely and play a role in determining value. The credit-worthiness of the issuers also varies considerably. In determining value, each issuer must be evaluated in terms of its ability to meet future principal and interest payments. With respect to liquidity, DBL was responsible for approximately 45 percent of the market in high yield bonds[5]. Accordingly, the liquidity in the secondary market for some high yield securities has been adversely affected by DBL's absence from the marketplace. The value of high yield securities generally has been decreasing during the last year. For example, the Merrill Lynch High Yield 175 Index has decreased 14 percent since July, 1989. However, it is difficult to determine the long-term impact of DBL's liquidation because it is hard to predict the extent to which other broker-dealers will, over time, absorb its market share.

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[5] "Market share" is based on the par value of high yield bond issues for which DBL was the lead underwriter. See Financing America's Future, 1989 High Yield Market Report, Drexel Burnham Lambert, 1989, p. 21.

Senator Jim Sasser
Question 3

Q.3. Mr. Breeden, today's Wall Street Journal indicates that the SEC has asked to join the creditors' committee in the bankruptcy proceedings in the Drexel case. Apparently, Drexel still owes the SEC $150 million, making the SEC its biggest creditor. This $150 million is part of a $350 million fund that Drexel agreed to set up for the benefit of the victims of its securities law violations. Is there a legal problem with the SEC, as a government agency, sitting on this committee even when the SEC is representing Drexel's victims? I venture to say that if there's anyone that deserves the $206 million in bonuses that Drexel paid out in the last few weeks, it's Drexel's victims. Is legislation required to make this happen?

A.3. The role of the Commission in the Drexel bankruptcy does involve some complex legal issues; although it is too early to say that legislation is required to resolve them in a satisfactory way.

On February 23, 1990, the Commission filed in the Drexel bankruptcy case a proof of claim stating that, pursuant to the terms of the final judgment entered in SEC v. Drexel Burnham Lambert, Inc., et al., 88 Civ. 6209(MP) (S.D.N.Y.), the debtor remains liable to the Commission for at least $150 million. Under the terms of that final judgment, dated June 20, 1989, based on allegations by the Commission that the debtor had engaged in numerous violations of the federal securities laws, the debtor agreed, among other things, to disgorge $350 million, to be paid in three installments unless otherwise directed by the district court, for the benefit of the victims of its violations of the federal securities laws. The first installment of $200 million, plus accrued interest, was paid on or before September 11, 1989. The balance of the disgorgement is due in two installments, the first due on or before September 11, 1990 and the second on or before September 11, 1992, unless ordered to be paid sooner by the district court. As a result of this claim, the Commission submits that it is the largest single creditor of the debtor.

The Group creditors' committee refused to grant voluntarily to the Commission ex officio status. For that reason, on February 28, 1990, the Commission filed in the bankruptcy court an emergency motion seeking an order to direct the U.S. Trustee to appoint the Commission to the Group creditors' committee. Pending adjudication of that motion, the Commission requested that the bankruptcy court grant the Commission interim relief. A hearing on the motion and the Commission's request for interim relief was adjourned until September 1990 pursuant to a Memorandum of Understanding between the Commission and the creditors' committee, which gives the Commission limited rights to confer with the committee and its counsel.

The question of the Commission's right to participate on a creditors' committee is a matter vested in the discretion of the United States Trustee, who is the official, under the Bankruptcy Code, who makes committee appointments. Under the Bankruptcy Code, generally governmental agencies are precluded from serving on committees because they are not "persons" within the meaning of the statute. An exception to that definition was enacted in 1984 by the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, at the request of the FDIC to permit that agency to serve on creditors' committees when it was acting as a receiver or liquidating agent for a bank. The Commission has argued that, where the proceeds of the disgorgement are to be used for the benefit of defrauded victims of Drexel, the Commission fits within the exception permitting governmental agencies to serve on committees enacted for the benefit of the FDIC. The United States Trustee declined to appoint the Commission but has not explained his reason for doing so.

Subsequently, on August 3, 1990, the Bankruptcy Judge approved and "so ordered" a Stipulation and Order Establishing the Securities Litigation Claimants Group and the Stipulation and Order Between the Securities Litigation Group and the Debtors Concerning the Disclosure of Documents. Under this Stipulation and Order, the Commission, along with the FDIC, became members of a Securities Litigation Claimants Group, which will be recognized by the Debtor, the Official Committees and the Court for purposes of negotiating a plan of reorganization and other relevant questions relating to the treatment of securities litigation claims in the bankruptcy proceeding. The Commission, therefore, has withdrawn its motion seeking appointment to the Group creditors' committee.

With respect to your inquiry concerning legislation, the Commission believes that, in view of the foregoing, it is premature to discuss whether additional legislation in this area is warranted.

Senator Jim Sasser
Question 4

Q.4. Mr. Breeden, yesterday's Washington Post carried a story about an SEC settlement with Dart Group -- the company controlled by Herbert Haft. Apparently the SEC has found that the Hafts violated securities laws when they didn't register their company as an investment company. If they had been so registered, they would not, according to the SEC, have been able to launch hostile takeover bids or reap greenmail profits by threatening takeovers. The Post gives a list of seven companies from which the Hafts reaped a total of $148 million in profits by putting companies in play without actually buying them. Now I'm glad you caught the Hafts, but there are no sanctions. I think this may send a signal that it's acceptable to break these laws. The Hafts did much to the detriment of a couple of major American corporate citizens, shouldn't there be severe penalties?

A.4. Because the Commission presently has no administrative fining or penalty authority, except in cases involving insider trading, these remedies were unavailable to us in the case of Dart Group Corporation. However, we do not view the injunction against the Dart Group committing future violations of the Investment Company Act's registration provisions as a hollow remedy. We believe this settlement sends a clear message to other market participants that the Commission stands ready to bring similar cases in the future. Recent passage of the "Enforcement Remedies Act" by the Senate will hopefully soon result in additional authority to assess fines for violators of the federal securities laws.

Senator Jim Sasser
Question 5

Q.5. One of the greatest uses of the junk bond in the 1980s was to finance hostile, highly-leveraged corporate takeovers. The junk bond marked a revolution in finance. And as we know, the vast majority of junk bonds was underwritten by Drexel Burnham. Because of Drexel and the junk bond, nearly every corporation in this country became vulnerable to the highly leveraged takeover. Is there going to be a significant slowdown in the takeover game as a result of the failure of Drexel? Is it possible that takeovers of the scale that we've seen over the last few years could reignite and be financed by other sources--the commercial and investment banks? Do you see a need for takeover legislation?

A.5. The nature of U.S. mergers and acquisition activity appears to be undergoing some adjustments. Because this change began before bankruptcy proceedings were initiated by Group, it may be difficult to determine what if any effects that bankruptcy has had on the M&A market. For example, Mergers & Acquisitions has reported a drop in the total number of M&A transactions of approximately 36 percent between the first and third quarters of 1989.

Similarly, the nature of M&A transactions has evolved since mid-1989. Leveraged acquisitions have slowed; the use of high yield bonds has been of decreasing significance as a source of acquisition financing in the past year. Mergers and Acquisitions reports that the number of leveraged buyouts dropped 43% between the second and third quarters of 1989. In part, bidders have returned to commercial bank loans as a primary source of acquisition capital.

The market likely will continue to explore alternatives to high yield bonds as a source of acquisition financing, including the use of equity financing in appropriate transactions. While more time is required to assess what effect the Drexel bankruptcy filing will have on these trends, I do not believe additional legislation is necessary in this area, apart from amending Section 13(d) to eliminate the filing "window," by shortening the filing period to five business days and requiring a person acquiring greater than five percent to standstill until filing, as the Commission has advocated. The Commission staff will be considering whether the Commission's rules impose unnecessary obstacles to common equity financing for acquisitions.

Senator Jim Sasser
Question 6

Q.6. Obviously a great number of firms across the country issued debt in the 1980's with junk bonds issued through Drexel Burnham. And a great number of these firms came to depend on Drexel for liquidity. What will be the impact on these firms now that Drexel has gone under? Will these firms suffer from financial hardship?

A.6. Beyond doubt, DBL played a large role in the high yield market. For the first nine months of 1989, DBL underwrote $8.6 billion of high yield securities, representing 42.7% of all newly issued securities of that type. It is still too early to measure the impact of the cessation of DBL operations upon the original issue market.

Group's bankruptcy filing appears to have had mixed effects upon the high yield market. On the one hand, DBL's cessation of its price quoting service has created some confusion in the market. On the other hand, other firms have begun to service those issues and, to the extent reliable price information is available, it appears that the market for large issue, actively traded high yield securities witnessed only a moderate decline in bond prices. This moderate reaction was believed by market participants to be a reflection of DBL's diminishing role in the market, due among other things, to increased competition and ongoing civil and criminal investigations into past activities. However, many smaller issues in which DBL was the sole or primary market maker have suffered substantial reductions in liquidity.

Senator Jim Sasser
Question 7

Q.7. Mr. Breeden, you have proposed that the SEC have some oversight over holding companies of broker-dealers -- the power to go in and assess the risk of the holding company's activities to the broker-dealer. In the case of the failure of Drexel, it looks like everything worked the way it was supposed to. As soon as the holding company tried to dip into the capital of the broker-dealer, the SEC -- to its credit -- stopped them. Investor customers of Drexel Burnham were fully protected by this action. Drexel filed for bankruptcy the next business day. The primary function of the securities laws is to protect investors. Is there something else in the Drexel affair that leads you to the conclusion that you need this new authority? Why should the SEC care whether Drexel failed or not, as long as investors are protected?

A.7. The Drexel credit squeeze resulted from a unique set of circumstances. Among other things, Drexel was a highly leveraged company; Drexel had unsecured short-term borrowings at the holding company level that were used to fund an increasingly illiquid portfolio of junk bonds, private placements and other investments; and the junk bond market experienced a steady decline in late 1989 and early 1990. Because of these and other circumstances unique to the Drexel situation, the Commission and other government regulators closely monitored the Drexel situation. These circumstances facilitated a coordinated and timely response by the Commission, other federal regulators, and SROs to the Drexel situation.

The Drexel occurrence underscores the Commission's need to have the authority to monitor the activities of broker-dealers' regulated affiliates and holding companies on a consolidated, world-wide basis so that it may adequately determine the potential exposure to regulated broker-dealers of adverse occurrences or circumstances affecting the broker-dealers' related entities. In order to maximize our flexibility in managing a failing firm situation, the Commission needs as much advance warning of a potential collapse of a broker-dealer's parent firm or its major affiliates as possible. This will enable the Commission to protect such a firm's customers and other broker-dealers, as well as to avoid possible adverse consequences on confidence in the securities markets.

It is imperative that the Commission have access to concrete "early warning" information regarding at least the other major unregulated financial operations carried out in the holding company system. With the ability to obtain this information quickly and on a systematic basis, the Commission would possess knowledge of the firms that are most unstable. Such information would be most valuable during a period of high stock market, interest rate or exchange rate volatility; the Commission would thus be in a better position to consult with SROs and domestic and foreign government agencies in order to plan possible responsive action and avoid further endangering the financial integrity of the securities industry. In addition to having obligations to customers, broker-dealers transact substantial amounts of business with other broker-dealers, clearing agencies and other financial institutions. Thus, the sudden collapse of one broker-dealer could cause serious repercussions throughout the industry absent effective and timely action by responsible agencies and SROs.